1999

Comment letters on proposed Audit and Accounting Guide, Life and Health Insurance Entities

American Institute of Certified Public Accountants. Committee on Insurance Accounting and Auditing. Audits of stock life insurance companies

AICPA

INTERNAL MEMO

Date: February 11, 1999

To: Karen Neloms

From: Elaine Lehnert (x6160)

Subject: Comment Letters - Life and Health Insurance Entities - Audit and Accounting Guide

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Karen,

Attached are the comment letters received on the exposure draft of the proposed Audit and Accounting Guide, *Life and Health Insurance Entities*.

Please retain the letters as part of the public record for one year.

Elaine

AICPA

Date: April 14, 1999

To: Pat Meyer, Library

From: Andrea Smith, Accounting Standards *as*

Subject: Additional comment letter (Life and Health Insurance Entities proposed Audit & Accounting Guide)

Enclosed is comment letter number **14** received in response to the exposure draft of the proposed Audit and Accounting Guide, *Life and Health Insurance Entities* and an updated comment letter log.

Please retain letter number **14** along with letters 1-13 and the comment letter log for one year as part of the public record.

Enclosures

List of Respondents to the Proposed Audit & Accounting Guide for Life and Health Insurance Entities

Letter Number	Respondent	Affiliation
1	Kevin Wilson	Sole practitioner
1a	Kevin Wilson	Sole practitioner
2	Daniel F. Case	Actuary
3	National Association of Insurance Commissioners	Professional Organization
4	Albert L. Peruzzo	Actuary
5	Trigon Blue Cross Blue Shield	Industry / Actuary
6	Financial Crimes Enforcement Network (letter 1)	Government
7	Deloitte & Touche LLP	Big 5
8	The Prudential Insurance Company of America	Industry
9	Financial Crimes Enforcement Network (letter 2)	Government
10	Ernst & Young LLP	Big 5
11	American Academy of Actuaries	Prof. Organization / Actuaries
12	Travelers Group	Industry
13	California Society of CPA's	State Society
14	PricewaterhouseCoopers LLP	Big 5

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12	Travelers Group	Industry
13	California Society of CPA's	State Society

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From: Kevin Wilson
26 Pine Street, Tivoli, N.Y. 12583
Oct. 5, 1998

(1) (1)

American Institute of Certified
Public Accountants
Harborside Financial Center
201 Plaza 3, Jersey City, N.J.
07311-3881

Rec'd 10/18/98

Dear Ms. Lehnert,

The Exposure Draft is very interesting. I was particularly impressed by the IMSA Life Insurance Market Program. Also that reporting is according to GAAP and on a Statutory basis. With the IMSA Handbook, the assessment process can be facilitated and the Assessment Questionnaire can be properly prepared. This will ensure honest sales practices throughout the insurance industry. The IMSA report, and the Affirmation of Independent Assessor will specify who is responsible for the contents in the report.

My experience in the Insurance industry was obtained in 1984 thru 1986. At American International Group, (AIG), I was employed by Transatlantic Reinsurance Company. However, I processed accounts in the Accounting Department for National Union Fire Insurance Co of Pittsburgh. Both Companies are subsidiaries of AIG. It was the Assumed Treaty and Facultative Pro-Rata reinsurance business. The inforce files were divided among the junior Accountants, and they were responsible for handling the processing, which was cash receipts, or disbursements, and recording in the Accounting records. The underwriting department was down one flight of stairs in case any accounts had to be researched. The Contracts, including covernotes and binders were located there. The reserves were; IBNR (incurred but not reported; Unearned Premiums, and outstanding losses. They were maintained on an ongoing basis.

Sincerely
Kevin Wilson

Kevin Wilson
26 Pine Street
Tivoli, New York
12583
10/15/98

Rec'd 10/20/98

AICPA
1211 Ave. of the Americas
New York, N.Y. 10036

(1A)

M/S ALL STARS

(1A)

Dear Ms. Lehnert,

Enclosed is an article from the Wall Street Journal on October 15, 1998. I think it relates to your recent exposure Draft for Life and Health Insurance Entities, File 3162.LG. It refers to a reverse mortgage product sold by two insurance organizations, Transamerica Corp. and Metropolitan Life Insurance Co. Also, the Commonwealth Insurance Company, selling annuites.

Sincerely
Kevin Wilson

WSJ 10/15/98
Wall Street Journal

AICPA
MEMBER SATISFACTION
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Please Turn to Page B4, Column 4

1A

LEGAL BEAT

Insurers Face 'Elder Abuse' Charge in Mortgage Suit

By RALPH T. KING JR.
Staff Reporter of THE WALL STREET JOURNAL

SAN MATEO, Calif.—For elderly homeowners, reverse mortgages can be a godsend, allowing them to receiv[e] payments that could help suppor[t] [...] til the end of their lives.

But a lawsuit filed here alle[ges] [...] reverse mortgage product sold [...] Transamerica Corp. and Metrop[olitan] [...] Insurance Co. had some unki[nd] [...] generating "unconscionable a[nd] [...] profits" and taking "advantage [...] by financial sleight-of-hand."

In less than four years, so[me] [...] homeowners wound up owing [...] times the amount of money they [...] The consumers got contracts s[...] these terms at length. But many [...] ers of the Transamerica/Met Li[fe] [...] Money Lifetime" product are i[n] [...] and 90s, and their lawyers con[...] may not have fully understoo[d] [...] tracts they signed. Some of the[m] [...] are mentally impaired.

At its core, a reverse mortgag[e] [...] ple product: A lender agrees [...] monthly payments to a homeowner-borrower, with the home's equity serving as collateral. The equity is used to repay the loan when the borrower sells the home, moves out or dies. The attraction for home-

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vided her $194,000 through August of this

Emptying the Nest

Reverse mortgages typically benefit elder[...]

ments even after the reverse-mortgage equity in her home was depleted.

Ms. Zalbidea was charged 9.5% compounded interest on a $73,535 annuity right from the start. While this required no ac[...] [...]idea, the [...] home eq[...] [...]n't collect [...]. And the [...], leaving [...]

[...]ted the [...] Cotchett, [...]n superior [...]leging "el[...] [...] misrepre[...] [...]an Mateo [...]e court to [...] represent [...]h reverse [...]ere under [...]o County. [...]rm says it [...]zen poten[...] [...]ion status [...]als. [...] Francisco, [...]e pending

Please Turn to Page B14, Column 5

②

Rec'd 11/23/98

Daniel F. Case
6716 Tildenwood Lane
Rockville, MD 20852
phone: (301)881-1832

Nov. 20, 1998

Elaine M. Lehnert
Technical Manager, Accounting Standards
File 3162.LG
American Institute of CPAs
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Exposure Draft Guide on Life and Health Insurance Entities

Dear Ms. Lehnert:

This letter contains suggestions for the proposed AICPA Audit and Accounting Guide on life and health insurance entities. I submit these suggestions solely on my own behalf. My qualifications to write on the subject are described in Attachment A.

My suggestions relate to the facts that the residual item in a mutual life company's GAAP balance sheet does not represent the company's surplus and that if it represents anyone's equity, it is the future policyholder's equity, not the present policyholders'. These facts are explained in my enclosed paper, "Presenting Mutual Life Insurers' U.S. GAAP Results." This paper is, except for the handwritten changes on page 6, identical to one I have submitted for possible publication in the *North American Actuarial Journal*. A condensed version of the paper that I submitted to *The Financial Reporter* (the newsletter of the Life Insurance Company Financial Reporting Section of the Society of Actuaries) is, I have been told, slated to appear in the next issue of that publication. As is indicated in the enclosed, research for my paper was supported by a grant from the Actuarial Education and Research Fund.

When the AICPA's SOP 95-1 was exposed for comment in 1994, I submitted a letter on the same point that I make here. In that letter, however, I did not address the "equity" aspect of the problem, and my explanations were not as thoroughly developed as I hope you will find them here.

Before setting forth my suggestions, let me comment on the importance of the subject I address. I have received an indication that some persons regard the issue as "only" a matter of captions, not a question of whether the numbers are correct. I submit that the captions in a financial statement are fully as important as the numbers. If the caption is wrong for the number, then the number is wrong for the caption.

My first suggestion is to add two paragraphs to the Guide that would set forth the crux of the matter. The first of the two new paragraphs would immediately follow proposed paragraph 8.65 (page 117; to be given whatever paragraph number would be appropriate in the final Guide) and would read as follows:

8.65a The interest and mortality rates described in paragraph 8.64 for calculating the net level premium reserve for death and endowment policy benefits will, typically, produce larger liability amounts than would result if interest and mortality rates were chosen in accordance with the first sentence of paragraph 8.45b. There is no conflict between the two paragraphs, however, since the net level premium reserve described in paragraph 8.64 is to be calculated without the explicit inclusion of the present value of future dividends to policyholders. The result is roughly the same as if future dividends (which typically are expected to increase in size with advancing age of a policy) were built into the calculation and interest and mortality assumptions based on "future expectations and trends" were used. Accordingly, future dividends (other than terminal dividends) are, in effect, accrued in the net level premium reserve. Terminal dividends will, as indicated in paragraph 86.5, ordinarily be accrued in a liability that becomes a component of the liability for future policy benefits mentioned in paragraph 8.64. The overall effect is that that liability accrues future dividends as well as death and endowment benefits. That fact, and the same fact where true of other types of contract, should be made clear in the appropriate balance-sheet captions.

The second of the two new paragraphs would immediately follow proposed paragraph 14.56 (page 303) and would read as follows:

14.56a The amount that appears as the residual item in a typical mutual life insurance entity's GAAP balance sheet does not represent the entity's surplus on a GAAP (or statutory) basis. Surplus, as is clear from the contractual provisions of participating policies, is the source of policyholder dividends. As explained in paragraph 8.65a, however, the liability for future policy benefits for SOP 95-1 contracts accrues future dividends to policyholders as well as future death and endowment benefits. It may be the case, furthermore, that the GAAP liabilities for future benefits for all other types of participating policies and contracts likewise accrue future dividends, either explicitly or implicitly. If so, then the residual item in the balance sheet represents only the portion of the entity's surplus that management expects not to return to the existing contractholders in the form of future dividends. Besides "surplus," the term "equity" would be incorrect, since in accounting parlance equity is where dividends come from, while it is not expected that current contractholders will receive any dividends from the residual amount discussed here. The term that should be used for the residual amount is "Margin After Future Dividends," the nature of which should be explained in a note to the financial statements. Instead of "Retained earnings," reference should be made to "Earnings to be retained," since the residual amount relates to the earnings that will have been retained when all future dividends to current contractholders have been paid. If the liabilities for some participating contracts do not accrue future dividends, the captions should instead be "Surplus Not Included in Liabilities" and "Earnings to be retained, plus portion of future dividends."

My remaining suggested changes or additions are designed to achieve conformity and completeness with regard to the matters discussed above. I shall give the suggestions in page order.

Page xx, paragraph P-5: Change "except for paragraph 11.13" to "except for the matters addressed in paragraphs 11.13, 8.65a, and 14.56a."

Page 30: In the right-hand box opposite "Liability for future policy benefits," insert "certain" in front of "contracts" in the fourth line. Provisions for adverse deviation are not made in the case of SOP 95-1 contracts.

Page 74, paragraph 10: In the third line, replace "future promised benefits" with "[future benefits/future promised benefits]", or the like, in order to reflect the fact that the GAAP liabilities cover future dividends as well as guaranteed benefits.

Page 117: No change other than to add the paragraph suggested above.

Page 302, heading preceding paragraph 14.54: Add "OR MARGIN" at the end of this heading, since the amount of GAAP surplus does not appear in a mutual entity's financial report.

Page 303: No change other than to add the paragraph suggested above.

Pages 304-5, paragraph 14.63: In the first line, insert "or Margin" after "Surplus." At the end of the fifth line of the paragraph, insert "(or margin)" after "surplus."

Page 305, third bulleted paragraph: In the fifth line, replace "entity" with "statutory."

Page 306, paragraph 15.3: In the sixth line, insert "stock" before "life."

Page 308, third paragraph of paragraph 15.6: In the first line, insert "stock" before "life."

Page 311, third line on page: Insert "stock" before "life."

Page 335, first paragraph: Immediately following the first sentence, insert the following two sentences: "The illustrative financial statements relate to stock life insurance entities. Following them is illustrative material reflecting the differences in treatment between stock and mutual life insurance entities." There could be a paragraph break immediately following these two added sentences.

Page 335, first paragraph: At the end of the third sentence, change "the specified authoritative literature" to "the text of this Guide and any other authoritative literature specified." This change would explicitly class the Guide as authoritative.

Pages 336-58: In the first line of the heading of each page, insert "Stock" between "ABC" and "Life."

Page 337: Change "Future policy benefits" to "Future policy benefits, including future dividends to policyholders." Change "Policyholders' dividends" to "Policyholders' current dividends." Note that these changes are appropriate for both stock and mutual entities.

Page 338: Change "Policyholder benefits" to "Policyholder benefits other than current dividends." Change "Policyholders' dividends" to "Policyholders' current dividends." These changes, likewise, are appropriate for both stocks and mutuals.

Page 359: Insert as a continuation of Appendix B the following:

MODIFICATIONS TO PRECEDING ILLUSTRATIVE MATERIAL TO REFLECT THE NATURE OF MUTUAL LIFE INSURANCE ENTITIES' REPORTS

For mutual entities:

Balance Sheet: "Future policy benefits" becomes "Future policy benefits, including future dividends to policyholders." "Policyholders' dividends" becomes "Policyholders' current dividends." [Note: these sentences will not be needed if my suggested changes for page 337, above, are adopted.] "Shareholders' Equity" becomes "Margin After Future Dividends" or "Surplus Not Included in Liabilities," whichever is applicable. The item referring to capital stock is omitted. "Retained earnings" becomes "Earnings to be retained" or "Earnings to be retained, plus portion of future dividends," whichever is applicable.

Statement of Income: The heading becomes "Statement of Earnings." "Policyholder benefits" becomes "Policyholder benefits other than current dividends." "Policyholders' dividends" becomes "Policyholders' current dividends." [Note: these sentences will not be needed if my suggested changes for page 338, above, are adopted.] "Income before income taxes" becomes "Period earnings to be retained, before income taxes" or "Period earnings to be retained, plus portion of future dividends, before income taxes," whichever is applicable. "Net income" becomes "Net period earnings to be retained" or "Net period earnings to be retained, plus portion of future dividends," whichever is applicable. The items referring to common shares are omitted.

Statement of Shareholders' Equity: The overall heading becomes "Statement of Margin After Future Dividends" or "Statement of Surplus Not Included in Liabilities," whichever is applicable. The column headed, "Capital Stock" is omitted. The column heading, "Retained Earnings" becomes "Earnings to be Retained" or "Earnings to be Retained, plus Portion of Future Dividends," whichever is applicable. The column heading, "Total Shareholders' Equity" becomes "Total Margin after Future Dividends" or "Total Surplus Not Included in Liabilities," whichever is applicable. "Net income for 19X1 [19X2]" becomes "19X1 [19X2] period earnings to be retained" or "19X1 [19X2] period earnings to be retained, plus portion of future dividends," whichever is applicable. The item referring to shareholders' dividends is omitted.

Statements of Cash Flows: "Net income" becomes "Earnings to be retained" or "Earnings to be retained, plus portion of future dividends," whichever is applicable. The item referring to dividends to shareholders is omitted.

Note 1, section headed, "*Organization*": "stock" becomes "mutual."

Note 1, section headed, "*Future policy benefits and expenses*": At the beginning of this section, the following paragraph is inserted: "Consistently with the treatment of current dividends to policyholders as expenses, the liabilities for future policy benefits and expenses under participating policies and contracts, except for [list any for which the following is not the case], take into account the payment of future dividends in amounts expected on the basis of the assumptions used. In the case of certain policies, future dividends are taken into account implicitly, by the use of significantly conservative assumptions as to future interest and mortality, rather than explicitly." In the first sentence of what then becomes the second paragraph, immediately after the words, "assumptions based," the phrase, ", except where future dividends are reflected implicitly by the means described in the above paragraph," is inserted. The beginning of the next-to-last sentence of the paragraph is changed so that the sentence reads: "Except where future dividends are reflected implicitly by the means described in the above paragraph, benefit liabilities for traditional life insurance contracts...."

Note 1, new sections: Following the section headed, "*Future policy benefits and expenses*," the following two sections are added:

Margin after future dividends [or *Surplus not included in liabilities*, if applicable]: This item represents the company's surplus minus the portion of that surplus that management expects, on the basis of the assumptions used, to return to the present participating policyholders and contractholders in the form of future dividends. [As an exception, because the liabilities for certain policies and contracts, as identified in the section on "*Future policy benefits and expenses*" above, do not reflect future dividends, this item incorporates no deduction from the amount of the surplus with regard to those policies and contracts.]

Period earnings to be retained [or *Period earnings to be retained, plus portion of future dividends*, if applicable]: This item is a measure of the company's period income, gain from operations, or earnings that excludes what management expects, on the basis of the assumptions used, ultimately to retain--that is, not to return to the present participating policyholders and contractholders in the form of future dividends. [As an exception, for the same reason as is discussed for certain policies and contracts in the section on "*Surplus not included in liabilities*" above, this item incorporates no deduction for future dividends with regard to those policies and contracts.]

Note 5: (?...I lack sufficient knowledge of life-insurance-company income taxation to be able to suggest any changes needed to make this note appropriate for mutual entities.)

Note 10: The first paragraph, which refers to stockholder dividends, is omitted, as are references to capital stock throughout the note. The following changes apply to the situation where all GAAP policy liabilities take future dividends to policyholders into account; suitable adjustments to the following would apply where that is not the case. In the last line of the paragraph that introduces the SAP/GAAP reconciliation, "net earnings (loss) and equity" becomes "period earnings (loss) to be retained and margin after future dividends." In the reconciliation, "GAAP net income" becomes "GAAP period earnings to be retained," and "GAAP equity" becomes "GAAP margin after future dividends." An asterisk is placed after the caption, "Future policy benefits and policyholders' account balances" in each place it occurs, and the following footnote is added: "* Contributing to this adjustment is the fact that the liability for future policy benefits takes future dividends into account under GAAP, but not under statutory accounting."

Page 379: Between the entries for "supplementary contract with life contingencies" and "surrender," insert: "surplus. The account identified in participating contracts as the source of dividends to contractholders." Note that the NAIC statements' treatment of dividends is erroneous in that it shows policyholder dividends as being deducted from income, not from surplus. Participating contracts themselves (those of mutual companies, at least, and presumably also those of stock companies), as well as accounting and actuarial literature, describe dividends as distributions of surplus. The amount that NAIC statements show for surplus itself is not affected by the error.

* * *

I wish to emphasize that, in my view, explaining the above matters in the notes alone would not be enough. The statement captions themselves should be accurate and not misleading.

I urge that, if your Task Force or other group encounters challenges to any of my assertions or suggestions, I be given a chance to respond. The debate over mutual-life-company GAAP has, over the decades, been marked by contention and confusion. I would be happy to travel to New York to discuss these matters with any AICPA group or groups that are involved.

Thank you for giving me this chance to comment.

Sincerely,

Daniel F. Case

Daniel F. Case, F.S.A.

Enclosure

2

Attachment A

Personal Qualifications to Comment on This Matter

B.S. *magna cum laude* in mathematics, Yale University, 1955.

B.S. *summa cum laude* in accounting, University of Maryland University College, 1997.

Fellow of the Society of Actuaries since 1963.

Member of the American Academy of Actuaries (AAA) since 1965. Member of the AAA Committee on Life Insurance Financial Reporting Principles, 1974-6, and chair of its Subcommittee on Accounting for the Participating Business of Stock Companies, 1975-6.

Employed by The Prudential Insurance Company of America (a mutual life insurance company), 1956-69. While there, worked for brief periods on dividend scales.

Employed by American Council of Life Insurance (ACLI) and predecessor organizations, 1969 to 1996. While there, served in staff capacity in support of the predecessors of the ACLI Committee on Generally Accepted Accounting Principles (early 1970's), Task Force on GAAP for Mutuals (early 1970's), and Committee on Statutory Financial Reporting Principles (early 1970's and for six weeks in 1993) and in support of the Task Force on Nonforfeiture Benefits for Universal Life Policies (early 1980's).

Note: The above information does not imply that anyone in any of the organizations mentioned here shares the views I express in this letter. As stated in the letter, I submit my comments solely on my own behalf.

Attachment to letter #2

Research for this paper was supported by a grant from the Actuarial Education and Research Fund--D. F. Case, 4/25/98.

PRESENTING MUTUAL LIFE INSURERS' U.S. GAAP RESULTS

ABSTRACT

A mutual life insurer's financial report that is prepared in accordance with generally accepted accounting principles in the U.S. does not show the amount of the company's surplus on the basis of those principles. Instead, it shows an amount representing the surplus minus some or all of the portion of that surplus that the company expects to return to the current participating policyholders. This paper documents the foregoing assertion. It then describes how the principally affected statement items were captioned in the 1996 U.S. GAAP reports of a sample of mutual life insurers and what supplementary information was provided. Finally, it suggests how such reports could caption the items more appropriately.

1. INTRODUCTION

In 1995, the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) promulgated rules which mutual life insurers must follow if they wish to prepare financial reports in conformity with generally accepted accounting principles (GAAP) in the U.S. The first calendar year for which the new rules were in effect was 1996.

A certain basic feature of the rules, and hence of the reports prepared under them, may not be apparent to many observers. In my view, the recipients of information contained in the reports should be given the best possible chance to understand the information correctly. To ascertain how well the mutual insurers had done in indicating the true nature of the information in their reports, I undertook a survey of 1996 U.S.

GAAP reports of mutual life insurers. This paper describes the basic feature of the GAAP rules that is my concern, what I found in the survey of GAAP reports, and how I suggest improving the reporting.

2. THE TRUE NATURE OF A MUTUAL LIFE INSURER'S U.S. GAAP REPORT

2.1 Nature and Operation of Mutual Life Insurers

A mutual life insurer has no stockholders. The company returns to some or all its participating policyholders, on a continuing basis, money that it does not reasonably need for policyholder protection or other purposes. Such returns are called "dividends."

A participating policy issued by a mutual life company contains various provisions regarding dividends. Typical of one such provision is the following sentence from a policy issued by The Mutual Life Insurance Company of New York in 1981: "While this Policy is in force, the share, if any, of the divisible surplus accruing on this Policy shall *be determined by the Company and allotted as a dividend at the end of each policy* year." It may be noted that this sentence indirectly defines "surplus" as the account from which dividends are deducted and "divisible surplus" as the amount of surplus that the company has determined it can return to policyholders in a given period.

Surplus derives from an excess of assets over obligations, as measured by whatever accounting principles are being used (internally or externally; I shall assume for this paper that state laws do not prohibit the disclosure of "surplus" as measured by means of accounting principles other than statutory).

The following discussion of mutual-life-insurer operations draws to some extent on the report of the Society of Actuaries (SOA) Task Force on Mutual Life Insurance Company Conversion (SOA, 1988).

2

Each new policyholder in an established mutual life company benefits from an accumulation of surplus contributed, primarily or entirely, by current and prior policyholders. Additional surplus typically arises from the transactions under the new policies. The largest amount of new surplus arises from participating policies for which the company charges premium rates significantly higher than what management thinks it will need to provide the benefits guaranteed in the policies. Typically, under such policies the company pays smaller dividends during the early policy years than it could afford to pay if it could be confident that things will go as well as its best estimate of future experience.

The policy year in which surplus begins to arise from new policies depends on the policy provisions, on actual events, and on the choice of accounting principles and actuarial assumptions. Some participating policies carry premiums that are relatively low in relation to the guaranteed benefits and are not expected to generate much surplus or receive much in dividends. Nonparticipating contracts, too (such as immediate annuities) are expected to generate a modicum of surplus, but will not receive dividends.

As time passes, if a relatively large amount of surplus has arisen under a particular block of participating policies, the company can begin to return to the remaining policyholders in the block a substantial portion of that amount (SOA, 1988, 362). That is because the company becomes increasingly confident that it can estimate reasonably closely the amount of money it will need to provide the promised benefits under the remaining policies in the block.

If the company wishes to protect against adversity, be able to respond to changing market conditions, and perhaps grow, it must maintain and perhaps increase its total amount of surplus on an ongoing basis. Since some blocks of policies may cause the company to lose money, others must make "permanent" contributions to surplus (SOA, 1988, 359). Accordingly, the company seeks to return to the typical block of policyholders something less than the amount of surplus, if any, that the block generates.

As I explain below, what a mutual life insurer's GAAP balance sheet shows instead of surplus is, in close or rough approximation, the surplus minus some or all of the portion of surplus that the company expects to return to its current policyholders. If what is shown excludes the entire amount of surplus that the company expects to return to the current policyholders, it is consistent in that respect with the following statement by a committee appointed by the SOA Task Force on Mutual Life Insurance Company Conversion: "Future dividends on participating policies are properly treated as obligations for management accounting purposes" (Life Insurance Company Financial Reporting Section Council, 1987, 2).

2.2 GAAP Treatment of Certain Long-term Participating Life Policies

Let us begin with the types of policy that got the most attention and debate while GAAP for mutual life insurers was being developed. These types of policy are defined by the FASB as participating life insurance contracts that meet both the following conditions:

a. The contracts are long-duration participating contracts that are expected to pay dividends to policyholders based on actual experience of the insurer.
b. Annual policyholder dividends are paid in a manner that identifies divisible surplus and distributes that surplus in approximately the same proportion as the contracts are considered to have contributed to divisible surplus (commonly referred to in actuarial literature as the contribution principle). (1995, par. 5)

The AICPA uses the same definition (1995, par. 5). Such policies account for a significant portion of the assets and dividends of many mutual life companies. I shall refer to them below as "long-duration contribution-principle participating life policies."

Under mutual-life-company GAAP there is to be held for such policies a "liability for future policy benefits" equal to the sum of:

a. The net level premium reserve for death and endowment policy benefits.

b. The liability for terminal dividends.

c. Any probable loss (premium deficiency) as described in paragraphs 35 to 37 of FASB Statement No. 60. (AICPA, 1995, par. 15)

The AICPA defines terminal dividends as "Dividends to policyholders calculated and paid upon termination of a contract, such as on death, surrender, or maturity" (1995, Glossary). Under GAAP they are to be accrued in the "liability for future policy benefits" if the following conditions are both met:

a. Payment of the dividend is probable.

b. The amount can be reasonably estimated. (AICPA, 1995, par. 17)

The AICPA notes that the two conditions ordinarily will be met (1995, par. 17). Terminal dividends, therefore, are normally accrued as part of the GAAP "liability for future policy benefits."

The next question is how annual dividends are treated. The answer to that question is not obvious on the surface. It lies in the rules set forth for the GAAP "net level premium reserve for death and endowment policy benefits": "The net level premium reserve should be calculated based on the dividend fund interest rate, if determinable, and mortality rates guaranteed in calculating the cash surrender values described in the contract" (AICPA, 1995, par. 16). If the dividend fund interest rate is not determinable, the rate used to calculate the guaranteed cash or other nonforfeiture

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values is to be used (AICPA, 1995, par. 16).

As described by Cody (1981, 318), a dividend fund is akin to an asset-share objective. For each policy, an asset-share account can be maintained that ascribes to the policy its share of actual premium and investment income, benefit costs, expenses, contributions to surplus, and dividends. The amount that management desires that account to attain at each policy duration (the dividend fund) is determined prior to issue. Actual dividends are determined as the amounts that can be paid, in the light of actual experience and in accordance with the contribution principle, while ~~maintaining~~ making the asset share equal the dividend fund from year to year.

In order to be reasonably sure that a block of policies will be self-supporting, the company sets the dividend-fund amounts at conservative levels. According to Kabele (1995, 348), possible levels include those obtained when statutory-type mortality and interest rates are used to calculate a statutory-type net level reserve, from which some or all the unamortized acquisition costs are then deducted. The "dividend fund interest rate" would be the interest rate used in calculating such a reserve. Kabele points out that the AICPA's specifications for the "net level premium reserve for death and endowment policy benefits" produce, in combination with the deferral and amortization of acquisition costs also called for, something that could serve as a dividend fund (1995, 349).

At any time it is possible to derive the dividends which can be paid to a policy throughout its remaining lifetime, while maintaining the dividend fund at each duration, if future experience duplicates current best-estimate. Since those dividends will be deducted from the ~~dividend fund~~ asset share just as benefits and expenses are deducted, the asset share and the dividend fund each make~~s~~ provision for, or accrue~~s~~, dividends as well as benefits and expenses. When viewed from the time of policy issue, the asset share and the dividend fund accrue~~s~~ both benefits and dividends entirely on the basis of best-estimate assumptions.

It may seem contradictory to refer thus to best-estimate assumptions if the dividend fund amount is based on conservative assumptions. Such a dividend fund amount is, however, determined without making any provision in the calculation for dividends. If it did make provision for the dividends that best-estimate experience will produce, calculation by use of conservative assumptions would not produce meaningful results.

U.S. GAAP for mutual companies' long-duration contribution-principle participating life policies (being discussed here) is based on best-estimate assumptions, as is evidenced by the following statement: "Because the liability for future policy benefits defined in this SOP generally follows the FASB Statement No. 97 model, AcSEC concluded that provision for adverse deviation should not be made" (AICPA, 1995, par. 52). Accordingly, the GAAP liability item must accomplish its accruals on the basis of best-estimate assumptions. As explained above, it does that, for insurers following the contribution principle, if it and the unamortized acquisition expense item together are considered to accrue dividends in the process.

The foregoing can be summarized simply, perhaps, by noting that there is a choice of ways to arrive at a policy liability that accrues dividends as well as benefits in a financial report that takes a best-estimate perspective: (1) use best-estimate assumptions and include anticipated future dividends explicitly in the calculation or (2) use significantly conservative assumptions and leave dividends out of the calculation. For long-duration contribution-principle participating life policies, mutual-company GAAP does the latter (except for the explicit treatment of terminal dividends).

The foregoing relates to the "liability for future policy benefits." Other features of U.S. GAAP for long-duration contribution-principle participating life policies are consistent with the above-described nature of the liability. For example, dividends paid are treated as expenses (AICPA, 1995, par. 14). That treatment would be inconsistent with a liability that did not make provision for the payment of dividends. Also, stock life insurers that issue participating policies are permitted to use the mutual-company GAAP rules for policies that have the characteristics of long-duration contribution-principle participating life policies (FASB, 1995, par. 6). Since stock life companies' liabilities must accrue policyholder dividends in order to be able to determine stockholders' equity, stock companies' use of a liability such as is specified for mutual companies is appropriate.

All indications are, therefore, that the U.S. GAAP "liability for future policy benefits" under a mutual company's long-duration contribution-principle participating life policies makes provision for future dividends as well as benefits. It must be noted, however, that the company's reported GAAP liability may differ from management's own dividend fund (or asset-share objective or the like). Hence the GAAP liability may be only a rough approximation to the liability that would make provision for the dividends that the company expects to pay if actual future experience duplicates best estimate.

2.3 GAAP Treatment of Other Policies and Contracts

The foregoing discussion pertains only to long-duration contribution-principle participating life policies. There follows a discussion of the other principal types of policy or contract involved.

Let us begin with universal life-type contracts, because of their implications for deferred annuities. The universal life-type contracts involved can be participating or, if issued by a stock life insurer whose results are consolidated with those of the mutual insurer, nonparticipating. If dividends under a participating universal life-type contract are expected to be negligible, then the product need not, presumably, be classed as a long-duration contribution-principle participating life policy for GAAP purposes.

The U.S. GAAP "liability for policy benefits" for a universal life-type contract is, essentially, its account balance or, in the absence of a stated account balance, its cash surrender value (FASB, 1987, par. 17). The account balance is, together with future premiums, the source of both future benefits and future dividends, if any. Therefore, in a financial report that takes a best-estimate perspective, the account balance makes provision for future dividends.

We have now the question of whether U.S. GAAP reports take a best-estimate perspective with respect to universal life-type contracts. That they do is indicated by the following statement, relating to the "liability for policy benefits": "Provisions for adverse deviation shall not be made" (FASB, 1987, par. 18). Further indication is given by the following statement, which relates to the amortization of deferred acquisition costs under universal life-type contracts: "*Estimated gross profit*, as the term is used in paragraph 22, shall include estimates of the following elements, each of which shall be determined based on the best estimate of that individual element over the life of the book of contracts without provision for adverse deviation..." (FASB, 1987, par. 23). Presumably, the foregoing two statements are what the AICPA was referring to in the sentence about provision for adverse deviation that is quoted above in connection with long-duration contribution-principle participating life policies. From them we may, likewise, conclude that GAAP reports take a best-estimate perspective with regard to universal life-type contracts. Therefore, the GAAP liabilities shown for those contracts make provision for future dividends.

Let us now turn to deferred annuities. For deferred annuities in their accumulation period, the U.S. GAAP liability is likewise, essentially, the account balance (FASB, 1987, par. 15). If GAAP reports take a best-estimate perspective with regard to deferred annuities in their accumulation period, then the liability for those annuities makes provision for future dividends.

The document that specifies the GAAP liability for deferred annuities in their accumulation period does not state what perspective is involved for them (FASB, 1987, par. 15). It is, however, the same document that specifies the liability for universal life-type contracts, discussed above. As indicated above, that document takes the same general approach, the "deposit" approach, to the valuation of both universal life-type contracts and deferred annuities in their accumulation period. The following remarks from that document, furthermore, indicate that the perspective with regard to deferred annuities is in at least one respect not what one might consider conservative:

> Several respondents suggested that the presence of an annuity purchase option constitutes a mortality risk....The Board concluded that...[a] mortality risk does not arise until the purchase provision is executed and the obligation to make life-contingent payments is present in an annuity contract (FASB, 1987, par. 40).

On the foregoing bases, my best guess is that the perspective taken for deferred annuities in their accumulation period is best-estimate. Accordingly, I judge that the GAAP liability for those contracts makes provision for future dividends.

Let us now turn to deferred annuities (other than variable annuities) in their payout period. For such contracts a "liability for policy benefits" is to be established on the basis of assumptions that include provision for the risk of adverse deviation (FASB, 1987, par. 16 and FASB, 1982, par. 21). The principally applicable document, originally written to apply only to stock life companies, also states:

> If limitations exist on the amount of net income from participating insurance

> contracts of life insurance enterprises that may be distributed to stockholders, the policyholders' share of net income on those contracts that cannot be distributed to stockholders shall be excluded from stockholders' equity by a charge to operations and a credit to a liability relating to participating policyholders' funds in a manner similar to the accounting for net income applicable to minority interests. Dividends declared or paid to participating policyholders shall reduce that liability...
>
> For life insurance enterprises for which there are no net income restrictions and that use life insurance dividend scales unrelated to actual net income, policyholder dividends (based on dividends anticipated or intended in determining gross premiums or as shown in published dividend illustrations at the date insurance contracts are made) shall be accrued over the premium-paying periods of the contracts (FASB, 1982, pars. 42-3).

Clearly, for stock life companies the total U.S. GAAP liability makes provision for future dividends to policyholders--at least, in the case of certain participating "insurance" or "life insurance" contracts . Whether the U.S. GAAP rules call for such provision in the case of mutual companies' deferred annuities in payout seems unclear. Consistency with the treatment of mutual insurers' long-duration contribution-principle participating life policies would dictate including such provision. It would seem that mutual insurers should be permitted to include such provision if they so desire. The provision could be made, presumably, by using either best-estimate assumptions with provision for adverse deviation and explicitly including expected dividends, or by using statutory-type assumptions with dividends left out of the calculation.

With respect to long-duration participating life policies that do not have the contribution-principle characteristic and are not universal life-type policies, the requirements for mutual insurers are similar to those described above for deferred annuities in payout. My conclusion with respect to them is the same.

With respect to all participating products not thus far discussed, it appears to me that a mutual company should be permitted to include provision for future dividends in its GAAP liability if it so desires.

Nonparticipating products need not be considered here. Their contribution to the residual balance-sheet amount is not influenced by the question of how to treat future dividends to policyholders.

2.4 Implications for the Residual Item in the Balance Sheet

As explained above, a mutual life insurer's report that follows the U.S. GAAP rules will include provision for future dividends in some portions of the policy and contract liabilities, while the picture with respect to other portions is unclear. To the extent that such provision is included, the residual item in the balance sheet falls short of the amount of the company's surplus (as measured on a GAAP basis). If this point is not immediately clear, Section 4 of this paper may help make it clearer.

In preparing its report, the company can caption the affected statement items in such a way as to communicate, with the help of supplementary information in the notes to the statements, the true nature of the report. I undertook a survey of mutual life insurers' 1996 U.S. GAAP reports to see how effectively they communicated their true nature. Section 3 of the paper describes the survey and what I found, while Section 4 comments on what I found and suggests a better approach to presenting the information.

3. SURVEY OF MUTUAL-LIFE-INSURER U.S. GAAP REPORTS

3.1 Scope and Nature of Survey

In May 1997 I wrote to about 4 dozen companies that I was reasonably sure were

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operating in the U. S. as mutual life insurance companies. I also wrote to a few fraternal organizations whose U.S. life-insurance operations I believed were subject to the mutual-life-insurer GAAP rules and to a few companies about which I was uncertain as to whether they were mutual life companies.

In my letters I asked each insurer: to send me its GAAP report if it had prepared one; if it had not prepared a GAAP report, to tell me whether, and if so approximately when, it planned to do so; and if it had prepared any items for external communication that referred to GAAP reports or to any GAAP numbers, to send me a copy of each type of such item.

About 6 weeks later I made telephone follow-ups to about 20 of the approximately 30 organizations that had not yet responded. I ultimately received written or oral responses from 30 organizations that were mutual life companies or fraternals. Of those, 11 organizations sent me copies of their 1996 GAAP reports (a condensed report in one case).

Most of the other 19 organizations informed me that they had not yet prepared GAAP statements. Many of those indicated that they were planning to prepare GAAP statements fairly soon, such as within the next year. A few organizations stated that they had prepared GAAP statements, but had not yet released them to the public. Since my survey sampling procedure was not rigorous, and since the purpose of the survey was not primarily to ascertain companies' future plans, I will not give any more precise information here except with respect to the GAAP reports I received.

Most of the GAAP reports I received were contained in an annual report resembling the reports that major stock corporations send annually to their shareholders. Two organizations sent me one or more related items in addition to their GAAP report. In view of my findings with regard to the GAAP reports themselves, there will be no need to comment on the additional items.

3.2 Captions of Key Statement Items in the Reports Received

The 11 GAAP reports I received were each accompanied by an unqualified opinion as to their conformity with GAAP (indirectly in the case of the condensed report). Five different accounting firms were represented among the 11 opinions.

Let us look first at the residual item in the balance sheet: the number obtained when the liabilities and a minority interest, if present, are subtracted from the assets. In describing how that item was captioned, I shall use the term "policyholders," regardless of whether the report used that term or a similar term such as "policyowners."

The residual item typically consisted of two or more items that were then totaled. The total was labeled "Total equity" in 6 reports, "Total policyholders' equity" in 1 report, and "Total policyholders' surplus" in 4 reports.

Among the minor components of the residual item, "Net unrealized investment gains," or the like, appeared in all 11 reports. "Foreign currency," or the like, appeared in 3 reports.

The major component of the residual item was captioned variously in the reports. It was captioned "Retained earnings" in 4 of the 6 reports in which the residual item was captioned "Total equity" and also in the report in which the residual item was captioned "Total policyholders' equity." In one of the 2 other reports using the caption "Total equity", the major component was captioned "Policyholders' equity," and in the other it was captioned "Surplus."

In the 4 reports using the caption "Total policyholders' surplus," the major component was captioned in the following 4 different ways: "Accumulated surplus," "Policyholders' surplus," "Unassigned surplus," and "Unassigned funds."

Now let us look at other statement items.

There was nothing in any of the liability-item captions to indicate that any of them included provision for future dividends, other than dividends payable. On the other hand, "future policy benefits" were commonly mentioned among the liabilities.

In the statement of operations (or "income" or "earnings"), 10 reports used the caption "Net income" and 1 the caption "Net earnings." In each case the income or earnings figure was combined with net unrealized investment gains and foreign-currency or minority-interest items, as applicable, to produce the year's change in the residual balance-sheet amount.

The statement of operations in each report except the condensed report contained a separate item for policyholder dividends. In most cases, that item was located under the heading "Benefits and expenses," or the like. When it was located under a heading such as "Benefits and other deductions," at least one item with a caption including the word "expenses" was also located under the same heading.

None of the reports included an item referring to policyholder dividends in the statement of (changes in) equity (or surplus).

3.3 Supplementary Information Provided in the Reports Received

There follows a summary of the relevant information given for each of several product types, as best I can determine, in the notes to the financial statements.

Long-Duration Contribution-Principle Participating Life Policies

Here is what each of the 11 reports indicated with regard to the policy liability:

. Net level premium reserves for death and endowment policy benefits, based on the nonforfeiture interest rate, ranging from [specific range of rates given], and mortality rates guaranteed in calculating the cash surrender values described in the contracts, plus the liability for terminal dividends.

. Net level premium method based on the guaranteed cash value basis for mortality and interest. Mortality rates similar to those used for statutory valuation purposes. Interest rates generally range from [specific rates given].

. Net level premium method and the guaranteed mortality and dividend fund interest. The mortality and interest assumptions are equivalent to statutory assumptions. Interest assumptions ranged from [specific rates given].

. Net level premium method, using interest rates and mortality tables used to calculate guaranteed cash surrender values.

. Net level reserves using same interest and mortality assumptions as used to compute the cash values.

. Net level premium reserve for death benefits, using dividend fund interest rates and mortality rates guaranteed in calculating cash surrender values. ...Dividends to policyholders based on estimates of the amounts to be paid for the period are reported separately as expenses.

. Net level premium reserve for death and endowment policy benefits, based on dividend fund interest rate and mortality rates guaranteed in calculating the cash surrender values described in the contract.

. Net level premium method and assumptions as to interest (dividend fund interest rate) and mortality (those guaranteed in the calculation of cash surrender values shown in the contract). [Note: this report contained some specific interest-rate information that I was unable to match up conclusively with the foregoing information.]

. [Discussed together with all other products except "nontraditional life products and deferred annuities."] Reserves calculated using net level premium method based upon assumptions regarding investment yield, mortality, morbidity, and withdrawal rates determined at the date of issue, commensurate with the company's experience.

[Mention of provision for adverse deviations from those assumptions "in certain cases."]

. [In the condensed report, no supplementary information pertaining to these matters given.]

. [In a full report, no supplementary information pertaining to these matters given.]

Universal Life-type Contracts

The reports described the liability in terms of the account value, in some cases stating that it was before deduction of surrender charges. A few reports gave a brief explanation of how the account values are derived.

Deferred Annuities in the Accumulation Period and Other Investment Contracts

The reports described the liability in terms of the account balance. A few of the reports did not identify deferred annuities separately from other investment contracts in giving the description.

Deferred Annuities in the Payout Period

Only two reports described the liabilities specifically with respect to deferred annuities in payout. One of those reports described the liability as the present value of expected future payments and gave a range of interest rates used. The other report merely gave the range of interest assumptions used. Neither report mentioned a provision for future dividends.

Other Products

For products other than those discussed above, the descriptions were generally in terms of a net level reserve using assumptions (in some cases described as being based on experience or on projected experience and in some cases described as being made at issue) as to such things as mortality, interest, and withdrawal, with provision for adverse deviation. No mention was made of a provision for future dividends.

Reconciliation to Statutory Results

Each report included a note concerning the differences between GAAP and statutory results. Following is a summary of each report's note.

- Reconciliations of statutory balance-sheet and operations-statement residual items to GAAP. Each reconciliation contained an item adjusting for future policy benefits. Accompanying text mentioned that statutory and GAAP life insurance reserves are based on different assumptions.
- Reconciliations of statutory balance-sheet and operations-statement residual items to GAAP. Each reconciliation contained an item adjusting for future policy benefits and an item captioned "Policyholder dividends." One-sentence qualitative elaboration on the reconciliations.
- Reconciliations of statutory balance-sheet and operations-statement residual items to GAAP. Each reconciliation contained an item adjusting for future policy benefits. Accompanying text mentioned, among ways in which statutory accounting differs from GAAP, that reserves for life and disability policies and contracts are based on statutory requirements.
- Reconciliations of statutory balance-sheet and operations-statement residual items to GAAP. Each reconciliation contained an item adjusting for insurance reserves and an item adjusting for dividend liabilities. No qualitative elaboration.
- (2 reports) Reconciliations of statutory balance-sheet and operations-statement residual items to GAAP items. Each reconciliation included an item adjusting for "policy" or "insurance and annuity" reserves. No qualitative elaboration.
- (2 reports) Reconciliations of statutory balance-sheet and operations-statement residual items to GAAP. Each reconciliation contained an item adjusting for future

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benefits. No qualitative elaboration.

. Summary statutory numbers given, but no reconciliation to GAAP numbers. Accompanying explanation indicating, among other things, that GAAP liabilities are based on "reasonably conservative" estimates of expected mortality, etc., rather than using "statutory" rates for mortality and interest.

. Statutory balance-sheet and operations-statement residual items given, but no reconciliation to GAAP numbers. Statement that the statutory liability for future policy benefits was computed using required valuation standards.

. Statutory balance-sheet residual item given, but no reconciliation. No qualitative elaboration.

There was no mention of dividends other than the two instances cited above.

4. COMMENTS AND SUGGESTIONS

4.1 Initial Basis of Discussion

As mentioned in Section 3.2, every GAAP report I received included policyholder dividends with benefits and expenses in its statement of operations; no report mentioned dividends in its statement of (changes in) equity (or surplus). Under accrual accounting, those facts imply that every participating policy or contract liability made provision not only for future benefits, but also for future dividends, if material. The statements and notes do not indicate, however, whether such provision was in fact made for any products.

As explained in Section 2.3, the GAAP rules for mutual insurers cause the liabilities for some products to make provision for future dividends and should, I believe, be interpreted as permitting mutual insurers to make such provision in the case of all other participating products. It seems desirable, for the sake of consistency, to treat all products the same way with regard to dividends. Since uniform treatment also makes the discussion easier, I shall first discuss a hypothetical report in which the liabilities for all participating products make provision for future dividends except as immateriality may permit otherwise.

Regardless of how the residual balance-sheet item is captioned, the liability item for policies and contracts should indicate that it is the liability for both future benefits and future dividends. The caption for the liability item for dividends payable would include the word "payable." Let us turn now to the choice of caption for the residual item.

4.2 Use of the Term "Equity"

Seven of the 11 reports used the term "equity" in captioning the residual balance-sheet item.

Some members of the public may interpret "equity" as meaning "surplus." That interpretation would be misleading, as I will discuss further in Section 4.3. It seems likely that other persons will interpret "equity" by analogy to their understanding of stockholders' equity.

Persons who know much about stockholders' equity know that it is where stockholders' dividends come from. At the end of each fiscal year, net income is carried ("closed") to retained earnings, a component of stockholders' equity. Dividend payments reduce stockholders' equity, not net income.

It seems likely that some persons seeing a reference to a mutual insurer's "equity" will conclude that it is where policyholder dividends come from, just as stockholder dividends come from stockholders' equity. Persons who are current participating policyholders may assume that the "equity" is where dividends paid to *them* come from. As explained in Section 2, however, the residual balance-sheet item in U.S. GAAP is where dividends to current policyholders do *not* come from (under the assumption, made for purposes of this discussion, that a liability for future dividends has been established for each participating product if material). Where the dividends do come from is similar to where benefits come from; it is from a portion of premium receipts and investment earnings plus, in some policy years, the liability for future dividends that is implicit in the policy liabilities.

Of course, under normal conditions the amount of dividends eventually paid to this year's current participating policyholders will exceed the amount of the current liability for future dividends. That will happen as a result of future premium receipts and investment earnings. Likewise, however, stockholders have a reasonable expectation that the dividends paid within their lifetimes will exceed the current amount of stockholders' equity. The point is that stockholders' equity is the source of dividends, while a mutual insurer's residual U.S. GAAP balance-sheet amount is not. Accordingly, I find "equity" to be a misleading term for the latter.

One may argue that, nevertheless, "equity" would fit the FASB's definition of that term. To be sure, the FASB has stated, "In a business enterprise, the equity is the ownership interest....[It] is the same as net assets, the difference between the enterprise's assets and its liabilities" (FASB, 1985, par. 60). At first glance, that definition would seem to fit the U.S. mutual-company GAAP situation. The FASB has, however, defined "liabilities" as follows: "Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to *other* entities in the future as a result of past transactions or events" (FASB, 1985, par. 35, emphasis mine).

A footnote to the foregoing definition of "liabilities" explains that obligations need not be hard and fast, legal obligations in order to be liabilities. The point here is not to quarrel with the treatment of future dividends as liabilities and their resultant exclusion from the residual balance-sheet item. The point is that if future dividends to current policyholders are a liability as defined by the FASB, they are a liability from the perspective of some entity *other* than the current policyholders.

Who might that other entity--the "owner(s)" of the "equity"--be? There are no stockholders. Past policyholders are out of the picture. Accordingly, the "owners" of the "equity" must be the future participating policyholders. Hence, if the residual item is "equity", it is "future policyholders' equity."

It would seem strange, of course, to consider future policyholders to be owners of the insurer, as would be implied by the FASB definition of "equity." Accordingly, the term "equity" seems ill-suited for use in a mutual insurer's report.

One may object to some of the foregoing reasoning by pointing out that if a mutual insurer is liquidated, the remaining assets will be distributed to the then existing policyholders. That is true, but the GAAP reports in question are on a going-concern basis, not a liquidating basis. On a going-concern basis, all the monetary interests of the current policyholders are reflected in the liabilities for benefits and (under GAAP) future dividends; only the future policyholders have an interest in the residual item.

One may further object by pointing out that it is possible that the mutual insurer will be converted to a stock company, in which case some or all of the residual balance-sheet amount may revert to the then existing participating policyholders in the form of cash or stock. That is also true, but the amount that may be received bears no determinable relation to the residual balance-sheet item, even as of the time of conversion. The SOA Task Force on Mutual Life Insurance Company Conversion concluded that whether or not a conversion is accompanied by a concurrent public offering of stock in the new company, the then existing participating policyholders' equity value in the new company will depend on the market value of the new company (SOA, 1988, 308-9). In discussing principles of legislation and regulation, the Task

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Force stated, "We believe that there is no entitlement of policyholders to any specific value and that book value measures of policyholder contributions are not appropriate measures of value in a world in which market-determined values are the ultimate standard" (SOA, 1988, 315).

Granted, when a stock corporation is acquired by another corporation, the price paid to stockholders of the acquired corporation likewise depends on market values, not on book values. Both situations, however, differ from the going-concern situation that the U.S. GAAP reports are designed to describe.

As explained above, the residual balance-sheet item in question cannot satisfy the FASB's definition of "equity" unless it represents the ownership interest of someone other than the present policyholders. It is the future policyholders' equity if the report is viewed in the light of ongoing operation as a mutual insurer. For various reasons, however, mutual life insurers may be reluctant to call the item "Future policyholders' equity."

A mutual life insurer may still be tempted to caption the residual item "Equity," or even "Policyholders' equity," and depend on the mention of future dividends among the liabilities, plus a note to the statements, to explain the true nature of the item. Such an approach seems questionable. The name given to the residual item is likely to be mentioned orally and in print without being directly followed by an explanation of the true nature of the item. Even though an explanation could be found in the financial statements and, presumably, from other sources as well, there would be many instances in which the explanation would be neither requested nor received. It is best to make the caption itself give as fully true a picture as possible.

Section 4.3 will discuss whether it is possible to give a satisfactorily true picture of the residual balance-sheet item in terms using the word "surplus."

4.3 Use of the Term "Surplus"

Here again I shall discuss a hypothetical report in which the liabilities for all participating products make provision for future dividends except as immateriality may permit otherwise.

As explained in Section 2, the residual balance-sheet item represents the surplus minus the portion of surplus that the company expects to return to the current participating policyholders. Accordingly, "Surplus" is an incorrect caption for the item. The caption that is needed is a condensation of the description given in the first sentence of this paragraph.

A term that has been mentioned now and then for more than two decades is "entity surplus." To those who have been in on the discussions, that term indicates "permanent" surplus--or, more rigorously, what is left of the "permanent" contributions of past and current policyholders and any others. To knowledgeable persons, then, the term conveys the desired meaning. It would seem, however, that other persons might quite possibly think that the "entity surplus" was the company's surplus. As discussed above, notes to the statements would be an inadequate aid in that case.

"Future policyholders' share of surplus" would be as accurate as "future policyholders' equity" and would not have the disadvantage of ascribing, technically, ownership to the future policyholders. Nevertheless, there might still be objections to labeling the item by reference to future policyholders.

"Surplus not allocated to current policyholders" might be confused with surplus itself, on the thinking that only the dividends already declared, or the like, have been "allocated" to policyholders. "Net surplus" might be similarly confused.

"Surplus after future dividends" might create the impression that there are two kinds of surplus: surplus before future dividends and surplus after future dividends.

"Surplus less provision for future dividends" would avoid creating that impression and would seem acceptable unless "provision," in U.S. GAAP parlance, can be used only in connection with income items, not with balance-sheet items, or is otherwise inappropriate for the purpose. If "provision" is inappropriate, "liability" or, perhaps, "reserve" could be used instead. In 2 of the 11 reports reviewed for this paper, the term "reserve" appeared in the balance sheet to denote the liability for future benefits (and dividends, where included).

Each of these last three possibilities seems rather cumbersome. To achieve something shorter, it may be necessary to avoid using either "equity" or "surplus" in the caption, as suggested in Section 4.4.

4.4 Use of Neither "Equity" nor "Surplus"

A term used both by actuaries in referring to an item of the nature being discussed here (Life Insurance Company Financial Reporting Section Council, 1987, 2) and by the FASB in defining "equity" (FASB, 1985, par. 60) is "net assets." Despite those uses, "Net assets" would be a misnomer. Items in the liability/equity section of a balance sheet do not represent assets; the FASB has described liabilities and equity as "mutually exclusive *claims to* or *interests in* the enterprise's assets" (FASB, 1985, par. 54, emphasis mine). In addition to being a misnomer, "Net assets" would fail to call attention to the fact that future dividends are treated as liabilities.

In somewhat the same vein, "Investment in future business," or the like, would be misleading. The term "investment" would encourage, or at least permit, the inference that the return on the "investment" would redound to the current policyholders. Since the entire monetary interest of the current policyholders is (on a going-concern basis, at least) reflected in the liabilities, that inference would be mistaken.

A caption having neither of the foregoing drawbacks may be "Margin after future dividends." To my knowledge, there is no particular reason for someone to assume that such a label refers to the surplus. A note to the statements could explain the caption's meaning. Unless "margin" has a generally accepted meaning that could make the caption misleading, "Margin after future dividends" might do.

4.5 If Not All Contract Liabilities Include Provision for Future Dividends

The discussion thus far in this section has assumed that all policy and contract liabilities in the report include provision for future dividends. If it is acceptable to leave such a provision out of the liability for one or more products, even if the omission makes a material difference, and if that is done, then the problem of choosing a caption becomes a bit more difficult.

The first thing to note is that the contract-liability items in the balance sheet should be separated, with those that include provision for both benefits and future dividends being so captioned and the others being captioned only as providing for benefits.

None of the captions suggested in Sections 4.2 through 4.4 for the residual balance-sheet item would be appropriate, since provision for future dividends would not have been made across the board. The residual item could be captioned "Surplus less provision (or "reserve" or "liability") for certain future dividends," or "Margin after certain future dividends," but the word "certain" might associate a certainty with future dividends that they do not deserve.

Substituting for "certain future dividends" in the foregoing something like "future dividends as indicated" would overcome the difficulty mentioned, but the label would appear strange in the absence of the report itself.

It might be possible to use "Surplus not included in liabilities." The reader or listener would at least be alerted to the fact that the residual item differed from the surplus. Reference to the report, including the notes to the statements, would identify the difference.

4.6 Other Statement Items and Related Notes

After correct captions for the balance-sheet liability and residual items are chosen, all other statement items should be conformed to them as appropriate.

If all GAAP items are correctly captioned, it should be possible to furnish a reconciliation of statutory results to GAAP if so desired. The mention of future dividends in the captions relating to any affected GAAP contract liability items will render the reconciliation between statutory surplus and the GAAP residual item accurate despite the difference in nature between those two residual items. The absence of a number indicating the amount of the provision for future dividends that has been made, however, will limit the informative capacity of the reconciliation. For example, a more informative reconciliation would show the difference between the GAAP and statutory contract liabilities, each without provision for future dividends, and then, separately, the amount of the GAAP provision (liability) for future dividends.

5. CONCLUDING REMARKS

None of the 11 1996 U.S. GAAP reports indicated their true nature. Those labeling the residual balance-sheet item as "equity" failed to indicate that if the item is indeed someone's "equity," it is the future policyholders' equity. Those reports labeling the residual item as "surplus" were simply incorrect.

If the report is consistent across product lines in its treatment of future dividends, my preferred caption for the residual balance-sheet item is "Surplus less provision for future dividends" or, for something shorter, "Margin after future dividends."

One of the 11 responding organizations sent, in addition to its 1996 report, its report for the first quarter of 1997. While its 1996 report referred to "Total policyholders' surplus," with a major component of "Accumulated surplus," its first-quarter 1997 report referred to "Total surplus," with a major component of "Equity." Although I do not favor any of those captions for mutual-life-company reports under the current U.S. GAAP, I welcome the fact that the organization was willing and able to change the captions it was using.

As of the writing of this paper, the AICPA was preparing for exposure a draft audit guide for insurers. I hope that the final version of that audit guide will contain appropriate guidance for the captioning of key statement items.

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Financial Accounting Standards Board. 1995. *Statement of Financial Accounting*

2

Standards No. 120: Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts. Norwalk, Ct.: Financial Accounting Foundation.

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MUTUAL ORGANIZATIONS RESPONDING TO SURVEY INQUIRY

Acacia Mutual Life Insurance Company

Aid Association for Lutherans

American United Life Insurance Company

Berkshire Life Insurance Company

Columbian Mutual Life Insurance Company

Educators Mutual Life Insurance Company

Farmers and Traders Life Insurance Company

General American Life Insurance Company

Guardian Life Insurance Company of America

John Hancock Mutual Life Insurance Company

Lutheran Brotherhood

Metropolitan Life Insurance Company

The Minnesota Mutual Life Insurance Company

Mutual of America Life Insurance Company

Mutual Trust Life Insurance Company

New York Life Insurance Company

Pacific Mutual Life Insurance Company

Pan-American Life Insurance Company

Phoenix Home Life Mutual Insurance Company

Principal Mutual Life Insurance Company

The Prudential Insurance Company of America

Security Mutual Life Insurance Company

Security Mutual Life Insurance Company of New York

Shenandoah Life Insurance Company

Standard Insurance Company

Sun Life Assurance Company of Canada

Teachers Insurance and Annuity Association

Trustmark Insurance Company

The Union Central Life Insurance Company

The Western and Southern Life Insurance Company

Rec'd 11/30/98 3

NAIC

120 West 12th Street
Suite 1100
Kansas City, MO 64105-1925
816/842-3600
816/471-7704 Main Fax
816/842-9185 Financial Services Fax

National
Association
of Insurance
Commissioners

November 24, 1998

American Institute of Certified Public Accountants
Elaine M. Lehnert
1211 Avenue of the Americas
New York, New York 10036-8775

Ms. Lehnert:

Thank you for the opportunity to comment on the Exposure Draft of the *Proposed Audit and Accounting Guide for Life and Health Insurance Entities* (the Guide). The following comments are respectively submitted after a cursory review of the Guide. This review was conducted by myself and the NAIC staff assigned to support the Codification Working Group.

Reference to Codification Project

There are several references to the recently completed NAIC Codification of Statutory Accounting Principles (Codification) project included in the Guide. For instance, P-7 states,

> "Codification is expected to result in a hierarchy of statutory accounting practices that will provide a comprehensive basis of accounting that can be applied consistently to all insurance entities."

We do not believe the reference to Codification in this context is appropriate based upon the results of actions taken by the NAIC and the AICPA in 1998.

As a historical reference, in 1995, the AICPA issued Statement of Position 95-5—*Auditor's Report on Statutory Financial Statements of Insurance Enterprises* (SOP 95-5) so that an auditor's opinion on a "prescribed or permitted" basis could continue until codification was completed. SOP 95-5 states "The codification is expected to result in a hierarchy of statutory accounting practices that will provide a comprehensive basis of accounting that can be applied consistently to all insurance enterprises." At that time, it was believed that once Codification was effective, in order for certified public accountants (CPAs) to issue opinions on statutory statements, SAP had to be considered an "Other Comprehensive Basis of Accounting" (OCBOA) by AICPA.

(3)

In 1998, the AICPA's Insurance Companies Committee determined that it would not be necessary for the Auditing Standards Board to grant Codification OCBOA status because NAIC Codification would not be the sole basis for preparing statutory financial statements. Further, auditors would be permitted to continue to provide audit opinions on practices prescribed or permitted by the insurance department of the state of domicile. While Codification is expected to be the foundation of a state's statutory accounting practices, it may be subject to modification by practices prescribed by a state's insurance laws and regulations or permitted by a state's insurance commissioner. Statutory financial statements will continue to be prepared on the basis of accounting practices prescribed or permitted by the states.

As state prescribed and permitted practices will continue be the basis of the audit opinion and due to the fact that Codification will simply replace the current *Accounting Practices and Procedures* manuals, we do not believe reference to Codification as "a hierarchy of statutory accounting practices that will provide a comprehensive basis of accounting that can be applied consistently to all insurance companies" is appropriate.

A review of the Guide found such references in paragraphs:

- P-7
- 3.7
- 15.26

Reference to current *Accounting Practices and Procedures* manual

As outlined in the above comment, Codification will take the place of the current *Accounting Practices and Procedures* manual for NAIC purposes on January 1, 2001. The Guide makes reference to the manual when illustrating the current statutory accounting treatment for specific transactions. In 2001, those references will need to be updated for changes in the manual. Examples include but are not limited to:

- 11.29 defines six alternatives for methods of equity investments in subsidiaries. SSAP No. 46 will only allow three methods.
- 11.75 illustrates current statutory accounting for real estate investments. SSAP No. 40 adopts SFAS No. 66 and 121 with modifications.
- 13.29 indicates that statutory accounting does not require a provision for deferred taxes whereas SSAP No. 10 will require such a provision.

In the first comment, we suggested that state prescribed and permitted practices should be referred to as SAP, but if reference is made to the *Accounting Practices and Procedures* manual, those references should illustrate the guidance that will be in place when the Guide is effective. Nevertheless, states still have the authority to prescribe or permit a practice that conflicts with Codification.

3

Definition of Prescribed Statutory Accounting Practices

As illustrated in paragraphs 3.8 and 5.58, the Guide defines prescribed SAP to include:

- state laws
- state regulations
- general administrative rules
- NAIC Annual Statement Instructions
- NAIC *Accounting Practices and Procedures* manual
- NAIC *Securities Valuation* manual (should be the *Purposes and Procedures Manual of the Securities Valuation Office*)
- NAIC official proceedings
- NAIC *Examiners' Handbook*

As noted in the first comment, SAP only includes state prescribed and permitted practices and therefore, reference to the NAIC publications is not technically correct. Many states reference at least some of these publications in their laws, regulations, and rules, but the NAIC publications only become the basis of SAP to the extent they are explicitly referenced by state law, regulation, or rule .

We have not reviewed the Guide in detail, therefore there may be additional references that are applicable to the comments above.

Again, thank you for the opportunity to comment on the Guide and please contact Dave Christensen (NAIC staff) at 816.889.4436 if you have any questions concerning our comments.

Norris Clark
Chair of the Codification of Statutory Accounting Principles Working Group
California Department of Insurance

Author: MIME:ALANDGEORGE@prodigy.net at INTERNET
Date: 11/30/98 11:31 PM
Priority: Normal
TO: Elaine M. Lehnert at AICPA3
Subject: Fw: Proposed Audit and Accounting Guide for Life and Health

pd 11/30/98
11-30-98

4

4

To: Elaine A. Lehnert,
Technical Manager, AICPA Accounting Standards
File 3162.LG

Subject: Proposed Audit and Accounting Guide for Life and Health Insurance Entities
I would like to express the following comments on the Proposed Audit and Accounting Guide for Life and Health Insurance Entities.

The proposed Audit Guide, while a worthy endeavor and a great improvement over the existing Audit Guide, has a significant flaw with regard to Deferred Annuities. A. In Section 8 in particular, it erroneously presumes that all deferred annuities have a cash surrender value. The truth is that some deferred annuities never have a cash surrender value (not even potentially just before the date they begin payout). This is particularly true of two classes of deferred annuities: 1. Structured Settlement Deferred Annuities (indeed, the existence of a cash surrender value would generally violate the tax rules for granting Structured Settlements their remarkably unique, "never-taxable to the annuitant" advantages). 2. Allocated Group Deferred Annuities sold to Qualified Pension Plans, especially those to enable Plan termination by the Plan Sponsor. B. In a closely related item, Section 8 also erroneously presumes that all Deferred Annuities are Investment Contracts. The fact is that there is a wide range of life-contingent probabilities involved in both of the kinds of Deferred Annuities I have referred to above (Structured Settlement Deferred Annuities and Allocated Group Deferred Annuities sold to Qualified Pension Plans to enable their termination by the Plan Sponsor). Here are four examples. Two of them are clearly Investment Contracts, one may be either an Investment Contract or a Limited Pay Contract depending on age and length of deferral period, and the last is clearly NOT an Investment Contract but is a Limited Pay Contract instead.

1. Some contracts will be "certain only, beginning at date xx/yy/zz", and are clearly Investment Contracts. 2. Some contracts will have a long period of certain payments scheduled, such as "20 years certain and life, beginning at date xx/yy/zz". For such contracts the life contingency is so remote and immaterial that they are also "Investment Contracts". 3. Some contracts will have a short period of certain payments scheduled, such as "5 years certain and life, beginning at date xx/yy/zz". For such contracts the life contingency may or may not be so remote and immaterial that they are "Investment Contracts". They may instead be "Limited Pay Contracts". 4. Some contracts will have no "certain" payments at all, and will completely lapse without any value (at a large profit to the insurer) if the annuitant dies before the scheduled beginning of payments. Like "Life-Only Single

4 cont'd.

Premium Immediate Annuities", the payment of any benefit at all is completely dependent on life contingencies. These deferred contracts clearly should be "Limited Pay Contracts", and not "Investment Contracts", according to the SFAS 97 basic definitions. Indeed, a large part of both the Structured Settlement Deferred Annuity market and the Termination of Qualified Pension Plan Defererred Annuity market fits item #4 above. They are NOT, repeat, NOT, Investment Contracts by the definitions of SFAS 97. They are Limited Pay Contracts instead.

It may be noteworthy that the main difference between calling otherwise identical annuity contracts "Immediate" or "Deferred" for statutory purposes under NAIC Actuarial Guideline IX is sometimes as simple as wether the first benefit payment is

anticipated (should the annuitant even live so long) to be 13 or less months from issue ("Immediate"), or more than 13 months from issue ("Deferred"). You could have nearly-identical contracts, neither with cash surrender values, one paying benefits 13 months from issue and the other 14 months from issue. The first would be called Immediate and the other would be called Deferred. The AICPA would presumably acknowledge the first as a Limited Pay Contract. I submit that the AICPA should acknowledge both as Limited Pay and not as Investment Contracts.

Sincerely yours, Albert L. Peruzzo, CPA*, MBA Fellow of the Society of Actuaries
Member, American Academy of Actuaries
*"Industry" Member, AICPA & Illinois CPA Society

Author: Elaine M. Lehnert at AICPA3
Date: 1/12/99 9:32 AM
Priority: Normal
TO: Andrea D. Smith
Subject: Re: Proposed Audit and Accounting Guide for Life and Health

4A

Forward Header

Subject: Re: Proposed Audit and Accounting Guide for Life and Health
Author: MIME:ALANDGEORGE@prodigy.net at INTERNET
Date: 12/5/98 3:51 PM

P.S. If you need to contact me by regular mail:

Albert L. Peruzzo
626 W. Aldine Ave. #2W 3
Chicago, IL 60657-3452

Phone: Day (312)822-4257; Evening:(773)871-8016

> From: Albert L Peruzzo <ALANDGEORGE@prodigy.net>
> To: elehnert@aicpa.org
> Subject: Fw: Proposed Audit and Accounting Guide for Life and Health
Insurance Entities
> Date: Monday, November 30, 1998 10:35 PM
> > To: Elaine A. Lehnert,
> Technical Manager, > AICPA Accounting Standards
> File 3162.LG
> > Subject: Proposed Audit and Accounting Guide for Life and Health
> Insurance Entities
> > I would like to express the following comments on the Proposed Audit
> and Accounting Guide for Life and Health Insurance Entities.
> > The proposed Audit Guide, while a worthy endeavor and a great
> improvement over the existing Audit Guide, has a > significant flaw with
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> deferred annuities have a cash surrender value. The truth is > that some
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particularly true of two classes of deferred annuities: > > 1. Structured
Settlement Deferred Annuities (indeed, the existence of
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> "never-taxable to the annuitant" advantages). > > 2. Allocated Group
Deferred Annuities sold to Qualified Pension Plans,
> especially those to enable Plan termination by the Plan Sponsor. > > B.
In a closely related item, Section 8 also erroneously presumes that
> all Deferred Annuities are Investment Contracts. > The fact is that
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> probabilities involved in both of the kinds of Deferred Annuities I >
have referred to above (Structured Settlement Deferred Annuities and
> Allocated Group Deferred Annuities sold to > Qualified Pension Plans to
enable their termination by the Plan
> Sponsor). Here are four examples. Two of them are clearly Investment
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> one may be either an Investment Contract or a Limited Pay Contract

4A

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> and the last is clearly NOT an Investment Contract but is a Limited Pay
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> such
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> lapse without any value (at a large profit to the insurer) > if the
annuitant dies before the scheduled beginning of payments. > Like
"Life-Only Single Premium Immediate Annuities", the payment
> of any benefit at all is completely dependent on life contingencies.
> These deferred contracts clearly should be "Limited Pay
> Contracts", and not "Investment Contracts", according to the SFAS 97
> basic definitions. > > Indeed, a large part of both the Structured
Settlement Deferred Annuity
> market > and the Termination of Qualified Pension Plan Defererred Annuity
market
> fits item #4 above. > They are NOT, repeat, NOT, Investment Contracts by
the definitions of
SFAS
> 97. They are > Limited Pay Contracts instead.
> > It may be noteworthy that the main difference between calling otherwise
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> Actuarial > Guideline IX is sometimes as simple as wether the first
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is
> > anticipated (should the annuitant even live so long) to be 13 or less
> months from issue ("Immediate"), > or more than 13 months from issue
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> Deferred. The AICPA would > presumably acknowledge the first as a Limited
Pay Contract. I submit
> that the AICPA should acknowledge both as
> Limited Pay and not as Investment Contracts.
> > > Sincerely yours, > > Albert L. Peruzzo, CPA*, MBA > Fellow of the
Society of Actuaries
> Member, American Academy of Actuaries
> *"Industry" Member, AICPA & Illinois CPA Society >

Rec'd 12/1/98

Author: MIME:mcellucci@mail.trigon.com at INTERNET
Date: 12/1/98 3:13 PM
Priority: Normal
TO: Elaine M. Lehnert at AICPA3
CC: sbeller@trigon.com at INTERNET, blauver@trigon.com at INTERNET,
pperkins@mail.trigon.com at INTERNET
Subject: comment on exposure draft

5

re: proposed audit and accounting guide for life and health insurance entities

I am a qualified actuary who is also an employee of my company. I take exception to the AICPA and other organizations requiring that an independent actuary be relied on for certain actuarial opinions in various reviews of company financial results. I am a professional and am held to a set of professional standards and ethics. There is an actuarial discipline board. Since I am an employee i know better than an outside actuary the characteristics of the business for which I am reviewing reserves. Yours is not the only organization to think independent is better. There are several moves to reject a qualified actuarial employee's opinion. Who do you think is paying for the independent actuary's opinion - the same company who pays the salary of the qualified actuarial employee. Independence doesn't guarantee better - it guarantees more expense and more time to gain the knowledge of the actuarial employee. Actuarial employees can be just as valuable, and in some cases more so, than independents. Please don't write us off.

Thanks for giving me an opportunity to give you my comments.

Marla Cellucci, M.A.A.A.
Trigon Blue Cross Blue Shield
2015 Staples Mill Road
PO Box 27401
Richmond, VA 23279

Rec'd 12/2/98

Author: MIME:CharlesK@fincen.treas.gov at INTERNET
Date: 12/2/98 4:23 PM
Priority: Normal
Receipt Requested
TO: Elaine M. Lehnert at AICPA3
Subject: Accounting Standards, File 3162.LG

6

Financial Crimes Enforcement Network
U.S. Department of the Treasury
Suite 200
2070 Chain Bridge Road
Vienna VA 22182-2536

Elaine M. Lehnert
Technical Manager, Accounting Standards, File 3162.LG AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Lehnert:

Thank you for this opportunity to comment on the proposed AICPA Audit and Accounting Guide Life and Health Insurance Entities that would supersede the AICPA Industry Audit Guide Audits of Stock Life Insurance Companies.

Money laundering is a phenomenon which affects a wide variety of financial service providers, including life and health insurance entities. As such, it represents a real risk, both legally and financially, to such entities. Insurance firms are increasingly becoming aware of this risk, and developing control procedures to better manage this risk.

Attached is a document that I believe would be useful to consider in formulating this Audit and Accounting Guide. The risk of money laundering to the insurance sector, as with all financial institutions is serious, and I believe that it may be useful to provide some description of this risk to those who audit life and health insurers. The importance of the accounting profession to the development of an effective anti-money laundering programme within an insurance entity cannot be overstated, and it is in that spirit that I provide you with this suggestion. If I can be of any further assistance to you or to your important efforts, please feel free to call me at (703) 905-3602.

Sincerely,

Charles D. Klingman
Senior Financial Institutions Policy Specialist

Attachment in Microsoft Word 6.0c format

Attachment H-6

Proposed Addendum to AICPA Audit & Accounting Guide

Life and Health Insurance Industry Developments – Money Laundering Risk and Related Regulatory Developments

(6)

Money Laundering Risk

Criminals use bank and non-bank financial institutions and professional advisors to launder the proceeds of crime, and the insurance industry is vulnerable. As discussed in Insurance Industry Developments – 1997/98 (*AICPA Audit Risk Alert: Insurance Industry Developments – 1997/98*, pp. 7-11) the evolving dynamics of the industry – mergers and acquisitions, expansion of core competencies, and diversification and more effective distribution of products generate important business opportunities, but they also generate risks for companies and auditors, including increased money laundering vulnerability. As these industry trends continue, as money launderers increasingly look for conservative, legitimate-appearing asset holdings, and as greater regulatory requirements for banks and other non-bank financial institutions make it more difficult for them to evade detection, the insurance industry will become increasingly vulnerable to money laundering and more attractive to money launderers. There is no industry more attractive to fraudsters generally than the insurance industry, and money launderers travel in similar circles. Finally, as state regulators and the SEC become increasingly focused on internal control and risk management, the compliance risk for insurance companies increases. The Know-Your-Customer principles of the insurance industry, traditionally focused on consumer protection, are rapidly evolving to also incorporate the meaning long-embraced by other financial institutions – to know the background and character of the customer, the source of his funds, and the purpose of his business activity.

What is money laundering?

Money laundering is the funneling of cash or other funds generated from illegal activities through legitimate businesses to conceal the initial source of the funds. Money laundering is a global activity and, like the illegal activities that give it sustenance, it seldom respects local, national or international jurisdiction. Current estimates of the size of the global annual "gross money laundering product" range from $300 billion to $1 trillion.[1]

While money laundering activity and methods become increasingly complex and ingenious, its "operations" tend to consist of three basic stages or processes -- placement, layering, and integration.

Placement is the process of transferring the actual criminal proceeds, whether in cash or in any other form, into the financial system in such a manner as to avoid detection by bank and non-bank financial institutions and government authorities. Money launderers pay careful attention to national laws, regulations, governance, trends and law enforcement strategies and techniques in order to keep their proceeds concealed, their methods secret, and their professional resources anonymous. The most common placement techniques include structuring[2] cash deposits into legitimate bank and other financial institution accounts and converting cash into other monetary instruments. Another important placement technique is the purchase at a premium of large checks made payable to third parties.

Layering is the process of generating a series or layers of transactions in order to distance the proceeds from their illegal source and to obfuscate the audit trail in doing so. Common layering techniques include outbound electronic funds transfer, usually directly or subsequently into a "bank secrecy haven" or a jurisdiction with more liberal record-keeping

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[1]By definition, money launderers are in the business of cloaking their activities and revenue, making approximation difficult.

[2]"Structuring" means breaking up large amounts of currency into smaller amounts in order to conduct transactions in such a manner as to avoid suspicion and detection.

and reporting requirements, and withdrawals of already-placed deposits in the form of highly-liquid monetary instruments, like money orders and travelers checks.

Integration, the final money laundering stage, is the unnoticed reinsertion of successfully laundered, untraceable proceeds into an economy. This is accomplished through a wide variety of spending, investing, and lending techniques and cross-border, legitimate-appearing transactions. An important placement technique is the purchasing of large investment vehicles like cash value policies with laundered funds in the form of monetary instruments or funds consolidated into legitimate-appearing accounts.

The world's largest and wealthiest economies tend to serve as the primary hosts for money launderers and their operations. These economies tend to harbor the greatest demand for illegal drugs, still the primary predicate money laundering activity. Also, sophisticated money launderers need similarly sophisticated financial services sectors in order to successfully launder -- to place, layer, and integrate proceeds.

Professional Guidance

The most applicable U.S. professional guidance for money laundering is provided by Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit*, and SAS No. 54, *Illegal Acts by Clients*.

The SAS No. 82 discussion of risk factors and assessment of risk is useful in dealing with money laundering as well as fraud. One important distinction is that money laundering is less likely to affect financial statements than other types of fraud and consequently is less likely to be detected in financial statement audits because the activity tends to use the business entity more as a conduit than as a direct hit on assets and operations.[3] A second important distinction is that fraudulent activity usually results in the loss or disappearance of assets or revenue whereas money laundering usually results in large quantities of illicit proceeds that need to be distanced from their source as quickly as possible in an undetected manner. For this reason, money laundering is more likely to cause misstatements upward than downward, and shorter-term fluctuations rather than cumulative changes. In applying SAS No. 82 to money laundering, judgment should similarly be used in identifying risk factors related to money laundering that may be present at an insurance company, including the following:

0A failure by management to display and communicate an appropriate attitude regarding internal control , especially (see the AICPA's publication entitled *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product No. 008883), pp. 105-108):

0Lack of Board / Senior Management oversight of critical processes and new, non-core business lines and products

Management's inattention to establishing independent reporting lines for key assurance functions, like internal audit and compliance

1Management's displaying a significant disregard for regulatory authorities

[3]One notable exception is that laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies that could result in material contingent liabilities during prosecution and adjudication of cases.

(6)

0Existence of a regulatory enforcement action, particularly citing compliance problems, control deficiencies, and concern over management's competence

1Prior examination findings not addressed or inadequately addressed

1Inadequate or insufficiently empowered compliance function, lack of professional resources, or lack of applicable experience

The lack of an independent internal audit compliance program.

2Evidence of unusual operating characteristics:

2Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.

3Significant premium payments emanating from or payment of claims going to "high risk" jurisdictions, notably "bank secrecy havens" and OFAC (Treasury's Office of Foreign Asset Control) targeted jurisdictions

4Significant and disproportionate revenues stemming from the redemption fees associated with early termination of permanent life insurance (i.e. universal, whole, and variable) or annuities

4Significant assets or revenues received in the form of currency, especially through non-captive agents

Significant and large premium payments made in money orders or travelers checks, especially when sequentially numbered.

5Abnormally regular property and casualty claims.

5A lack of background checks on new hires

Weak or non-existent ethics policies and related training programs

Unreasonably infrequent or non-existent reviews of security software and systems.

While the auditor does not ordinarily have a sufficient basis for recognizing possible violations of laws and regulations that may indirectly effect the financial statements, this discussion underscores the importance of auditors responsibilities with regard to possible illegal acts by clients. Auditors should design their audits to provide reasonable assurance of detecting material misstatements resulting from illegal acts that have a direct and material effect on the determination of financial statements amounts. However, an audit performed in accordance generally accepted auditing standards does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements. Auditors should, however, be aware of the possibility that such illegal acts have occurred. Specific guidance in this area is set forth in SAS No. 54, *Illegal Acts by Clients*.

*   *   *   *   *

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Legislative and Regulatory Developments

Bank Secrecy Act
The Bank Secrecy Act (BSA), enacted to address the problem of money laundering, authorizes the U.S. Department of the Treasury to issue regulations requiring financial institutions, to file reports, keep certain records, implement anti-money laundering programs and compliance procedures, and report suspicious transactions to the government (see 31 CFR Part 103). Failure to comply with BSA reporting and recordkeeping provisions may result in the assessment of severe penalties. Insurance companies are defined as financial institutions under the Act (Title 31 USC 5312(a)(M)).

Suspicious Activity Reporting
Insurance companies are not currently required to report suspicious activity either by employees or customers to the Treasury Department. However, a number of major insurance companies are voluntarily complying with this provision. Insurance companies that are subsidiaries of bank holding companies are required to report suspicious activity by the Federal Reserve (12 CFR 225).

Currency Transaction Reporting
BSA implementing regulations require financial institutions including companies to file Currency Transaction Reports (CTRs) for cash transactions greater than $10,000. (31 CFR 103.22)

Other BSA Reporting Rules
Other BSA rules governing the reporting of international transportation of currency or monetary instruments (CMIRs) and foreign bank and financial accounts (FBARs) have not been modified since 1989 and 1987 respectively. However, on January 16, 1997 (see Federal Register) the Treasury issued a proposal to expand the statutory definition of monetary instruments to include foreign bank drafts.

State Statutes
According to the National Association of Attorneys General, thirty states have enacted legislation prohibiting money laundering. Additional states are currently considering such legislation.

European Union Directive on Money Laundering

On July 13, 1998 the European Union expanded the scope of Directive 91/308/EEC to require auditors and lawyers to report suspicious activity. This directive would apply to the audits of the European operations and subsidiaries of domestic clients.

Rec'd 12/3/98

Deloitte & Touche

7

Deloitte & Touche LLP
Ten Westport Road
P.O. Box 820
Wilton, Connecticut 06897-0820

Telephone: (203) 761-3000

December 2, 1998

Ms. Elaine M. Lehnert
Technical Manager
Accounting Standards
American Institute of CPAs
1211 Avenue of the Americas
New York, NY 10036-8775

File Reference No. 3162.LG
Audit and Accounting Guide, Life and Health Insurance Entities

Dear Ms. Lehnert:

We are pleased to comment on the proposed AICPA Audit and Accounting Guide, *Life and Health Insurance Entities*, dated September 4, 1998 (the "Exposure Draft"). Overall, we support the issuance of the Exposure Draft as a final Audit and Accounting Guide. Some suggestions for clarification are provided below.

GAAP Financial Statement Disclosures

Paragraph 3.18 lists sources of guidance on disclosures specific to life insurance entities. We recommend adding SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*.

Derivative Financial Instruments

Paragraphs 11.32 through 11.39 discuss accounting for, and disclosure of, derivative financial instruments. The final Audit and Accounting Guide should, at a minimum, refer to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

If you have any questions regarding our response, please contact Phillip Callif at (203) 761-3695 or John Smith at (203) 761-3199.

Yours truly,

Deloitte & Touche

Deloitte Touche Tohmatsu

Prudential

(8)

Martin A. Berkowitz
Senior Vice President & Comptroller

The Prudential Insurance Company of America
213 Washington Street, Newark NJ 07102-2992
Tel 201 802-7279 Fax 201 802-9065

Rcv'd 12-4-98

December 2, 1998

Ms. Elaine M. Lehnert
Technical Manager, Accounting Standards (File 3162.LG)
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Re: Exposure Draft, "Proposed Audit and Accounting Guide - Life and Health Insurance Entities"

Dear Ms. Lehnert:

Prudential is pleased to have the opportunity to comment on the above Exposure Draft. We understand that the Proposed Audit and Accounting Guide does not seek to modify generally accepted accounting principles applicable to life and health insurance companies, other than to incorporate the SEC staff guidance contained in Topic D-41, "Adjustments in Assets and Liabilities for Holding Gains and Losses Related to the Implementation of FASB Statement No. 115." Consequently, our comments are of a technical nature and relate to certain elements of the discussions of statutory accounting and reporting practices and separate accounts.

Paragraph 3.7 states that the NAIC currently has a project under way to codify Statutory Accounting practices (SAP) through a complete revision of its Accounting Practices and Procedures Manuals, which when complete is expected to replace prescribed or permitted SAP as the statutory basis of accounting for insurance entities. Additionally, paragraph 15.22 indicates the expectation that states will require the preparation of statutory financial statements using accounting practices "prescribed in the NAIC's Accounting Practices and Procedures Manual." It was recently determined that in fact, the statutory basis accounting for insurance entities will be based on practices that are prescribed or permitted by state insurance regulatory authorities, which may incorporate the standards contained in the revised Accounting Practices and Procedures Manuals with or without modification. Prudential recommends that the wording of paragraphs 3.7 and 15.22 be amended to reflect the current status.

Paragraph 11.7 states that the NAIC issued a Model Investment Law which provides guidelines for insurers to follow in purchasing investments. As of this date, the NAIC has issued two Model Laws relative to investments, one of which deals with investment limitations and the other with investment standards. Prudential recommends that the wording of Paragraph 11.7 be amended to reflect the issuance of two Model Investment Laws.

Paragraph 14.3 identifies "Goodwill and similar intangible assets" as examples of nonadmitted assets. However, Statement of Statutory Accounting Principles No. 68, "Business Combinations and Goodwill," states that positive goodwill recorded under the statutory purchase method of accounting shall be admitted, within specified limitations. Prudential recommends that goodwill be described similarly to the other assets that may be admitted within specified limitations in paragraph 14.4

Paragraph 15.22 states that when codification is complete, it is anticipated that a statutory basis for accounting for insurance entities other than NAIC-codified statutory accounting will be considered neither

8 cont'd

GAAP nor an other comprehensive basis of accounting (OCBOA) under SAS No. 62, "Special Reports." A similar reference is contained in Paragraph 15.26. It is currently anticipated that statutory financial statements prepared in accordance with practices prescribed or permitted by state insurance regulatory authorities will continue to be regarded as OCBOA statements following the completion of codification. Prudential recommends that the wording of paragraphs 15.22 and 15.26 be amended accordingly.

Paragraph 14.15 indicates that a separate account is a "legally restricted fund that is segregated from all other assets of the life insurance entity." While, as explained later in that paragraph, separate account funds are generally not available to cover liabilities except those of the separate account, we note that these assets are, in fact, owned by the insurance company (as discussed in Statement of Statutory Accounting Principles No. 89) rather than by a separate legal entity. Accordingly, Prudential suggests that the separate account be described as a "fund that is segregated from all other assets of the life insurance entity in which the assets are held for the benefit of the separate account contractholders." Alternatively, a clarification of the meaning of "legally restricted" in the first paragraph of Paragraph 14.15 may be helpful.

Paragraph 14.26 makes reference to the GAAP guidance contained in FASB Statement No. 60, paragraph 54, for separate accounts with guaranteed investment returns. Some expansion of the discussion of separate accounts that provide guaranteed investment returns may be helpful here in providing guidance as to types of contracts that may require evaluation of facts and circumstances in order to determine the appropriate accounting treatment. For example, is the significance of the guarantee and the likelihood of its invocation to be considered in classifying a contract under Paragraph 54? Also, while it may seem evident that separate account assets which are reported in accordance with paragraphs 45-51 of FASB Statement No. 60 are subject to the same investment disclosures (under Statements No. 107 and 115) as general account assets and separate account assets reported in a single line presentation at fair value are not subject to those disclosures, it may be useful to clarify this in Paragraph 14.26. Prudential understands that the subject of accounting and reporting for separate accounts is under study by an AICPA Task Force and that these issues may be addressed by that Task Force, perhaps in a separate document, rather than in the Proposed Audit and Accounting Guide for Life and Health Insurance Entities.

Prudential supports the objectives of the Proposed Audit and Accounting Guide to provide consistent and comprehensive guidance. We are pleased to submit our comments and we hope they will be considered as you finalize this guidance.

Sincerely yours,

(9) Rec'd 12/7/98

FINANCIAL CRIMES
ENFORCEMENT NETWORK
2070 Chain Bridge Road, Suite 200, Vienna, VA 22182, Telephone (703) 905-3520

THE DEPARTMENT OF THE TREASURY 1789

December 2, 1998

Elaine M. Lehnert
Technical Manager,
Accounting Standards, File 3162.LG
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Lehnert:

Thank you for this opportunity to comment on the proposed AICPA Audit and Accounting Guide Life and Health Insurance Entities that would supersede the AICPA Industry Audit Guide Audits of Stock Life Insurance Companies.

I offer only one general comment - the need for the audit guide to acknowledge and provide guidance on the vulnerability of the insurance industry to abuse by money launderers. Money laundering is a phenomenon which affects virtually every form of financial services provider, including life and health insurance entities. As such, it represents a real risk, both legally and financially, to such entities. Insurance firms are increasingly becoming aware of this risk, and developing control procedures to better manage this risk.

Attached is a document that I believe would be useful to consider in formulating this Audit and Accounting Guide. The risk of money laundering to the insurance sector, as with all financial institutions is serious, and I believe that it may be useful to provide some description of this risk to those who audit life and health insurers. We believe that the accounting profession should and must play a critical role in the development of an effective anti-money laundering program, and it is in that spirit that I provide you with this suggestion. If I can be of any further assistance to you or to your important efforts, please feel free to call me at (703) 905-3930 or Charles Klingman at (703) 905-3602.

Sincerely,

Peter G. Djinis

Peter G. Djinis
Associate Director

Financial Crimes Enforcement
Network (FinCEN), Department
of the Treasury

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Proposed Addendum to AICPA Audit & Accounting Guide

Life and Health Insurance Industry Developments –

Money Laundering Risk and Related Regulatory Developments

Money Laundering Risk

Criminals use bank and non-bank financial institutions and professional advisors to launder the proceeds of crime, and the insurance industry is vulnerable. As discussed in Insurance Industry Developments – 1997/98 (*AICPA Audit Risk Alert: Insurance Industry Developments – 1997/98*, pp. 7-11) the evolving dynamics of the industry – mergers and acquisitions, expansion of core competencies, and diversification and more effective distribution of products generate important business opportunities, but they also generate risks for companies and auditors, including increased money laundering vulnerability. As these industry trends continue, as money launderers increasingly look for conservative, legitimate-appearing asset holdings, and as greater regulatory requirements for banks and other non-bank financial institutions make it more difficult for them to evade detection, the insurance industry will become increasingly vulnerable to money laundering and more attractive to money launderers. There is no industry more attractive to fraudsters generally than the insurance industry, and money launderers travel in similar circles. Finally, as state regulators and the SEC become increasingly focused on internal control and risk management, the compliance risk for insurance companies increases. The Know-Your-Customer principles of the insurance industry, traditionally focused on consumer protection, are rapidly evolving to also incorporate the meaning long-embraced by other financial institutions – to know the background and character of the customer, the source of his funds, and the purpose of his business activity.

What is money laundering?

Money laundering is the funneling of cash or other funds generated from illegal activities through legitimate businesses to conceal the initial source of the funds. Money laundering is a global activity and, like the illegal activities that give it sustenance, it seldom respects local, national or international jurisdiction. Current estimates of the size of the global annual "gross money laundering product" range from $300 billion to $1 trillion.[1]

While money laundering activity and methods become increasingly complex and ingenious, its "operations" tend to consist of three basic stages or processes -- placement, layering, and integration.

Placement is the process of transferring the actual criminal proceeds, whether in cash or in any other form, into the financial system in such a manner as to avoid detection by bank and non-bank financial institutions and government authorities. Money launderers pay careful attention to national laws, regulations, governance, trends and law enforcement strategies and techniques in order to keep their proceeds concealed, their methods secret, and their professional resources anonymous. The most common placement techniques include structuring[2] cash deposits into legitimate bank and other financial institution accounts and converting cash into other monetary instruments. Another important placement technique is the purchase at a premium of large checks made payable to third parties.

Layering is the process of generating a series or layers of transactions in order to distance the proceeds from their illegal source and to obfuscate the audit trail in doing so. Common layering techniques include outbound electronic funds transfer, usually directly or subsequently into a "bank secrecy haven" or a jurisdiction with more liberal record-keeping

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1 By definition, money launderers are in the business of cloaking their activities and revenue, making approximation difficult.

2 "Structuring" means breaking up large amounts of currency into smaller amounts in order to conduct transactions in such a manner as to avoid suspicion and detection.

and reporting requirements, and withdrawals of already-placed deposits in the form of highly-liquid monetary instruments, like money orders and travelers checks.

Integration, the final money laundering stage, is the unnoticed reinsertion of successfully laundered, untraceable proceeds into an economy. This is accomplished through a wide variety of spending, investing, and lending techniques and cross-border, legitimate-appearing transactions. An important placement technique is the purchasing of large investment vehicles like cash value policies with laundered funds in the form of monetary instruments or funds consolidated into legitimate-appearing accounts.

The world's largest and wealthiest economies tend to serve as the primary hosts for money launderers and their operations. These economies tend to harbor the greatest demand for illegal drugs, still the primary predicate money laundering activity. Also, sophisticated money launderers need similarly sophisticated financial services sectors in order to successfully launder -- to place, layer, and integrate proceeds.

Professional Guidance

The most applicable U.S. professional guidance for money laundering is provided by Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit*, and SAS No. 54, *Illegal Acts by Clients.*

The SAS No. 82 discussion of risk factors and assessment of risk is useful in dealing with money laundering as well as fraud. One important distinction is that money laundering is less likely to affect financial statements than other types of fraud and consequently is less likely to be detected in financial statement audits because the activity tends to use the business entity more as a conduit than as a direct hit on assets and operations.[3] A second important distinction is that fraudulent activity usually results in the loss or disappearance of assets or revenue whereas money laundering usually results in large quantities of illicit proceeds that need to be distanced from their source as quickly as possible in an undetected manner. For this reason, money laundering is more likely to cause misstatements upward than downward, and shorter-term fluctuations rather than cumulative changes. In applying SAS No. 82 to money laundering, judgment should similarly be used in identifying risk factors related to money laundering that may be present at an insurance company, including the following:

- A failure by management to display and communicate an appropriate attitude regarding internal control , especially (see the AICPA's publication entitled *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product No. 008883), pp. 105-108):
    - Lack of Board / Senior Management oversight of critical processes and new, non-core business lines and products
    - Management's inattention to establishing independent reporting lines for key assurance functions, like internal audit and compliance
- Management's displaying a significant disregard for regulatory authorities

[3] One notable exception is that laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies that could result in material contingent liabilities during prosecution and adjudication of cases.

- Existence of a regulatory enforcement action, particularly citing compliance problems, control deficiencies, and concern over management's competence

- Prior examination findings not addressed or inadequately addressed

- Inadequate or insufficiently empowered compliance function, lack of professional resources, or lack of applicable experience

- The lack of an independent internal audit compliance program.

- Evidence of unusual operating characteristics:

  - Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.

  - Significant premium payments emanating from or payment of claims going to "high risk" jurisdictions, notably "bank secrecy havens" and OFAC (Treasury's Office of Foreign Asset Control) targeted jurisdictions

  - Significant and disproportionate revenues stemming from the redemption fees associated with early termination of permanent life insurance (i.e. universal, whole, and variable) or annuities

  - Significant assets or revenues received in the form of currency, especially through non-captive agents

  - Significant and large premium payments made in money orders or travelers checks, especially when sequentially numbered.

  - Abnormally regular property and casualty claims.

- A lack of background checks on new hires

- Weak or non-existent ethics policies and related training programs

- Unreasonably infrequent or non-existent reviews of security software and systems.

While the auditor does not ordinarily have a sufficient basis for recognizing possible violations of laws and regulations that may indirectly effect the financial statements, this discussion underscores the importance of auditors responsibilities with regard to possible illegal acts by clients. Auditors should design their audits to provide reasonable assurance of detecting material misstatements resulting from illegal acts that have a direct and material effect on the determination of financial statements amounts. However, an audit performed in accordance generally accepted auditing standards does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements. Auditors should, however, be aware of the possibility that such illegal acts have occurred. Specific guidance in this area is set forth in SAS No. 54, *Illegal Acts by Clients*.

* * * * *

Legislative and Regulatory Developments

Bank Secrecy Act

The Bank Secrecy Act (BSA), enacted to address the problem of money laundering, authorizes the U.S. Department of the Treasury to issue regulations requiring financial institutions, to file reports, keep certain records, implement anti-money laundering programs and compliance procedures, and report suspicious transactions to the government (see 31 CFR Part 103). Failure to comply with BSA reporting and recordkeeping provisions may result in the assessment of severe penalties. Insurance companies are defined as financial institutions under the Act (Title 31 USC 5312(a)(M)).

Suspicious Activity Reporting

Insurance companies are not currently required to report suspicious activity either by employees or customers to the Treasury Department. However, a number of major insurance companies are voluntarily complying with this provision. Insurance companies that are subsidiaries of bank holding companies are required to report suspicious activity by the Federal Reserve (12 CFR 225).

Currency Transaction Reporting

BSA implementing regulations require financial institutions including companies to file Currency Transaction Reports (CTRs) for cash transactions greater than $10,000. (31 CFR 103.22)

Other BSA Reporting Rules

Other BSA rules governing the reporting of international transportation of currency or monetary instruments (CMIRs) and foreign bank and financial accounts (FBARs) have not been modified since 1989 and 1987 respectively. However, on January 16, 1997 (see Federal Register) the Treasury issued a proposal to expand the statutory definition of monetary instruments to include foreign bank drafts.

State Statutes

According to the National Association of Attorneys General, thirty states have enacted legislation prohibiting money laundering. Additional states are currently considering such legislation.

European Union Directive on Money Laundering

On July 13, 1998 the European Union expanded the scope of Directive 91/308/EEC to require auditors and lawyers to report suspicious activity. This directive would apply to the audits of the European operations and subsidiaries of domestic clients.

ERNST & YOUNG LLP
1285 Avenue of the Americas
New York, New York 10019
Phone: 212 773 3000

Rec'd 12/7/98

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December 7, 1998

Ms. Elaine M. Lehnert, Technical Manager
Accounting Standards, File 3162.LG
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Proposed Audit and Accounting Guide
Life and Health Insurance Entities

Dear Ms. Lehnert:

We support the timely issuance of the Proposed Life and Health Insurance Entities Audit and Accounting Guide ("the Guide") because the current industry guide available to practitioners is outdated and as such, does not consider numerous accounting and auditing pronouncements relevant to life and health insurance entities, most of which have been addressed in this Guide. Because the Guide currently does not consider all accounting (e.g., FASB Statement 133 on derivatives) and auditing pronouncements through its issuance date of September 4, 1998, we strongly urge AcSEC to complete, on a timely basis, the updating prior to final issuance. However, if this would result in a lengthy delay, we prefer issuing the Guide in its current state and updating it as soon as possible thereafter. In that case, we strongly suggest that commentary be added to the forepart of the Guide that clarifies what existing guidance, as of the ultimate issuance date, is not included. This concern and other comments, that we believe warrant revisions to the Guide prior to its issuance, are discussed below.

Omission of Existing Guidance

As indicated on page 335, the Guide has not been updated for FASB Statements subsequent to No. 127. While reference is made as to the intent to update the Guide for FAS 133 and the NAIC's codified statutory accounting principles prior to its final issuance, it is unclear how that may be accomplished without significantly delaying the Guide's issuance date, considering that the changes could be substantial. To the extent these updates have already been drafted, we encourage exposing them to a limited distribution for comment as soon as possible so they may be incorporated into the Guide with minimum delay.

Although we prefer that the Guide be updated prior to its final issuance, we are concerned that if the updates will take a long period of time, it will be that much more difficult to actually complete the Guide in 1999. (The project already has taken many, many years.) If significant delay is likely, we believe it is preferable to issue a final Guide now, in its current form, with full disclosure of its status and update it as soon as possible thereafter. Because of the complexity of updating it for FAS 133 and codified statutory accounting principles as well as other relevant pronouncements, we recommend that a task force be formed to accomplish this.

To best alert the reader as to the existence of authoritative literature not reflected in the Guide, we recommend that the *Preface* to the Guide include a listing, including their effective dates, of relevant accounting and auditing standards existing at the Guide's date of issuance but for which the Guide has not been fully updated. Pronouncements specifically relevant to life and health insurance entities that seem to have been excluded from the Guide, include the following:

- FAS 133, *Accounting for Derivative Instruments and Hedging Activities*
- FAS 131, *Disclosures about Segments of an Enterprise and Related Information*
- FAS 130, *Reporting Comprehensive Income*
- SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts that do not Transfer Insurance Risk* (applicable to short-duration contracts only)
- SAS 87, *Restricting the Use of an Auditor's Report*
- NAIC's Codified Statutory Accounting Principles

Because the Guide is typically used as a reference material, we further recommend that the pronouncements cited in the *Preface* be cross-referenced to applicable sections of the Guide and those sections include a footnote that alerts the reader to the pronouncements for which the section had not been updated and refers them to the *Preface* for further discussion.

Emphasis-of-a-Matter Paragraphs

We suggest that the guidance with respect to emphasis paragraphs in Chapter 15, sections 6, 37 and 38, be amended to encourage adequate disclosure in the footnotes regarding an entity's failure to meet minimum RBC standards and the use of significant permitted accounting practices as opposed to encouraging the use of an emphasis paragraph within auditors' reports to highlight these matters. In issuing SAS 79, *Amendment to Statement*

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on Auditing Standards No. 58, "Reports on Audited Financial Statements," the Auditing Standards Board believed that because uncertainties are required to be adequately disclosed in the financial statements, there is no need for reference to these matters in an explanatory paragraph to the auditors' report. For the same reason, we believe that an emphasis paragraph is unnecessary when the matter is adequately disclosed in the financial statements. Therefore, we recommend that the use of an emphasis paragraph for these two matters described in Chapter 15 should not be encouraged. With respect to an entity's failure to meet minimum RBC standards, we also suggest that the Guide be revised to indicate that the auditor should consider this matter in the context of a going concern opinion.

Illustrative Financial Statements

With respect to the Illustrative Financial Statements in Appendix B, we suggest that Note 8 disclose losses incurred arising from both the current and prior year and that the prior year development be explained in the footnote. Essentially, this addition would provide the practitioner with an example of the disclosures identified in 10b and 11 of Appendix C.

Illustrative Letter of Qualifications

While the Illustrative Letter of Qualifications in Exhibit 5.3 has been updated to reflect changes for SAS 82, *Consideration of Fraud in a Financial Statement Audit*, it also needs to be updated for minor editorial changes that were made prior to its final release in a *Notice to Practitioners* that appeared in the September 1998 *CPA Letter*.

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We would be pleased to discuss our comments and recommendations with members of the Accounting Standards Executive Committee or its staff.

Sincerely,

Ernst + Young LLP

(11)

AMERICAN ACADEMY of ACTUARIES

1100 Seventeenth Street NW Seventh Floor Washington, DC 20036 Telephone 202 223 8196 Facsimile 202

December 10, 1998

By Electronic Mail
and First Class Mail

Ms. Elaine M. Lehnert
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, N.Y. 10036-8775

Dear Elaine:

Enclosed please find the comments of the Financial Reporting Council of the American Academy of Actuaries on the proposed Audit and Accounting Guide *Life and Health Insurance Entities* issued by the American Institute of Certified Public Accountants. These comments were prepared with substantial participation by the Academy's Committee on Life Insurance Financial Reporting and Health Practice Council. We appreciate the opportunity to comment, and hope that our observations will be useful to the AICPA as it finalizes the Guide.

The Financial Reporting Council would welcome the opportunity to provide any further analysis or drafting assistance that AICPA might find helpful or to discuss its comments with appropriate AICPA representatives. If you require any additional information or assistance, please contact me or Academy staff members John H. Trout, Lauren M. Bloom or Ali Arouri.

Sincerely,

Lawrence A. Johansen
Vice President
Financial Reporting

Encl.

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comments to the
american institute of certified public accountants
on proposed audit and accounting guide
life and health insurance entities
of the
financial reporting council
of the
american academy of actuaries

December 10, 1998

AMERICAN ACADEMY *of* ACTUARIES

1100 Seventeenth Street NW Seventh Floor Washington, DC 20036 Telephone 202 223 8196 Facsimile 202

The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

These comments were prepared by the Financial Reporting Council of the Academy, with substantial participation by the Academy's Committee on Life Insurance Financial Reporting and Health Practice Council.

Lawrence A. Johansen, Chairperson
William C. Weller, Vice-Chairperson
David G. HartmanEdward L. Robbins
Leonard KolomsDonald E. Sanning
Michael G. McCarterSusan T. Szkoda
Bruce MooreJane Taylor
Donna C. NovakPatricia Teufel
Dennis M. PolisnerJames F. Verlautz
James ReiskytlRobert E. Wilcox

Introduction

The Financial Reporting Council of the American Academy of Actuaries (the Academy) has reviewed the Proposed Audit and Accounting Guide *Life and Health Insurance Entities* (the Guide) issued by the American Institute of Certified Public Accountants (AICPA). Our comments reflect the substantial participation of the Academy's Committee on Life Insurance Financial Reporting and Health Practice Council. Based upon our experience in the life and health insurance industries, we believe that some revisions would strengthen the Guide, ultimately improving its value as an auditing tool.

Our comments fall into three categories. Our most substantive comments follow. Appendix One to these comments addresses instances in the Guide where we believe some examples in addition to those used by AICPA might be helpful to an auditor with little life and health insurance background, or where the AICPA's examples might benefit from some minor changes in wording. Appendix Two to these comments addresses sections of the Guide where we believe alternative language might be used to improve the clarity or accuracy of the text.

Substantive Comments

Section 5.37 (page 50) refers to the use of specialists by management in making actuarially-determined estimates. The language used appears to us to be rather generic in its discussion of whether an actuary is competent to participate in the audit process, and it implies that the AICPA is responsible for establishing the standards of qualification for an actuary to practice in this area. In fact, actuaries' qualification obligations are established by the *Code of Professional Conduct* and *Qualification Standards for Prescribed Statements of Actuarial Opinion* of the Academy. We suggest that this point be clarified.

Similarly, we are concerned by the implication in the last sentence of Section 5.40 (page 51) that an auditor can be considered a qualified actuary solely by virtue of "level of competence." Individuals who have not attained membership in the Academy or one or more of the Academy's sister organizations are not bound by the *Code of Professional Conduct* or the *Qualification Standards for Prescribed Statements of Actuarial Opinion* of the Academy. In our view, such individuals are not qualified to perform actuarial work, and should not be considered "qualified actuaries" whatever their alleged level of competence. We recommend that an individual be considered a "qualified actuary" only if that individual is a member of the Academy or, perhaps, if that individual has received prior approval to perform actuarial work by the appropriate regulatory body. We therefore recommend that the last sentence of Section 5.40 be revised to state that "If the auditor is not a qualified actuary for purposes of the review, the auditor ... "

Section 7.13 (page 84) defines GAAP net premium, but we believe the definition could be

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improved by revising it to read, "The GAAP net premium is defined as the portion of the gross premium needed to provide for all contract benefits (benefit premium) and maintenance and settlement expenses (maintenance premium), as well as to fund the amortization of the deferred acquisition costs (DAC) asset (acquisition expense premium)." The additional definitions in this sentence should also prove useful elsewhere in the Guide.

Section 7.16 (page 85) does not reference AICPA Practice Bulletin No. 8 as an interpretive guide for SFAS 97. We do not believe the Practice Bulletin has ever been withdrawn, and it is widely used for current guidance. Is the Guide intended to replace AICPA Practice Bulletin No. 8? If so, that intent should be stated here or elsewhere in the Guide.

We believe Section 7.22 (page 87) to be incorrect. For investment contracts that do not have significant sources of profit other than interest spread, we understand that a level interest rate approach should be used to project the gross fund (given the initial consideration), and a different level interest rate should be used to project the net fund (initial consideration less the acquisition expenses). The gross fund becomes the benefit reserve, and the difference between the two funds becomes the DAC. A clear distinction should be made in the Guide between these contract types and those that follow the Universal Life model.

The last sentence of Section 8.23 (page 110) appears to contain some inadvertently redundant wording. We recommend striking the first part of the sentence so that the sentence begins, " Increases or decreases in reserves resulting from changes in the basis of valuation or other changes...".

We disagree with Section 8.42's (page 113) statement that the conceptual approach of calculation of liabilities under GAAP and SAP are generally the same. We suggest striking the phrase "the same as," and substituting "similar to."

We would suggest subdividing Section 8.45 (page 114) into separate sections for SFAS 60, SFAS 91, and SFAS 97 contracts to make the comparison more accurate depending on the class of products. We also believe that the next several pages of the Guide might be clearer if they were subdivided in this manner.

We question the relevance of the second sentence of Section 8.56 (page 116) as written. We would suggest that it be revised to state, "The GAAP Benefit Reserve will often be less than the aggregate cash values of all contracts outstanding. Further, the GAAP net liability (benefit reserve less deferred acquisition cost) will be less still more frequently. In the latter case, a GAAP book loss occurs on surrender." This becomes a factor as well in Section 8.112 (page 127), where a PAD for lapse may not be conservative if there are gains on surrender.

Sections 8.71-72 (page 118) appear to imply that all deferred annuities have two phases, and that the second phase doesn't depend on the election of the policyholder. To eliminate this erroneous implication, we suggest that Section 8.72 begin as follows: "The second phase, at the election of the policy holder, is..."

Section 8.73 (page 119), while relatively short, appears to us to contain significant errors and not to add substance. It seems to attempt to describe the individual account value as the proper reserve under GAAP accounting. If that is this section's intent, we suggest it be stated clearly.

Section 8.87 (page 121) does not appear to be correct. It is our understanding that, where the right of distribution to shareholders of earnings on participating business is limited, a participating liability is established on the balance sheet, that the contribution to the participating liability is the dividend expense, and that actual payment or crediting of dividends is taken against such participating liability. We request that this point be clarified here.

With respect to the sections on auditing statutory reserve adequacy and GAAP benefit liabilities (Sections 8.98 through 8.121), we have several general comments. First, the auditor's testing seems to be limited to tests of the reasonableness of assumptions. There is little mention of tests relating to reserve calculations themselves, trends in reserves, tracing of reserve entries and procedures to ensure that all liabilities are accounted for. Additionally, the guidance provided on premium deficiency or loss recognition testing does not seem to us to offer much help in practice. We question whether this section expects tests to be done on homogeneous blocks, and whether these tests need to be satisfied at issue, during the life of a contract or both. We also question whether the testing procedures are intended to be different for each.

Second, the attachment of audit objectives and examples of procedures seems to be more on point relating to our comments above. We suggest that some of these attachment ideas be translated into the narrative of the chapter.

Third, we question whether the chapter should make reference to overall audit objectives of reserves and liabilities, for example: 1) adequacy of liabilities; 2) proper statement of income; 3) consistency of reporting with prior periods; and 4) incidence of earnings created by reserving methodologies ("big picture" perspective). Should the chapter also indicate the significance and relative magnitude of these items and the significant effect they have on income and surplus reporting?

Our specific suggestions for each section are as follows:

Section 8.99 (page 125) and the subsequent sections do not always make clear whether it is the auditor performing these procedures or the auditor with the assistance of a qualified outside actuary. We suggest this point be clarified.

It is also unclear from Section 8.99 whether these are the only acceptable procedures for auditing statutory reserve adequacy. We note that the procedures set forth in this section relate to cash flow testing only, and question whether procedures should also be set forth for testing of reserve calculations, tracing reserve calculations into entries, trending of reserve results (which is useful given the generally predictable pattern of statutory reserves for certain contracts), testing of the application of appropriate statutory valuation assumptions, etc. Additionally, triangulations of claim reserve and liability developments for group health and similar lines are an important means of testing reserve adequacy, and should perhaps be reflected in this section.

The first bullet of Section 8.99 (page 125) should require the auditor to discuss the cash flow testing with the appointed actuary, since that is the person responsible for the testing. We suggest that this bullet read, "Discuss the cash flow testing with the appointed actuary and management ..."

Section 8.104 (page 126) appears to be suggesting the "lock-in" principle of assumptions for certain life insurance contracts. If so, we suggest that it be more clearly stated.

Section 8.106 (page 126) addresses asset share studies. We believe these asset share studies or at-issue assumptions should be compared with current allocated asset portfolio performance. We also question whether this section intends to refer to original asset share studies or current gross premium valuations, and suggest this point be clarified.

Section 8.107 (page 126) makes reference to Section 8.106 as discussing adequacy of gross premiums. Clarification of Section 8.106 would make this section correct.

We also question why an auditor would use current new money rates to test the interest assumption of an inforce block. This may be appropriate for new business or new money. We believe the auditor should determine if allocations of invested assets are made to the inforce business and test the performance, as well as the expected performance of those assets, against the interest assumptions of the inforce block. New money rates may have some bearing on the analysis to the extent the insurance liabilities are supported with recurring premium deposits or maturities of existing assets.

In Section 8.108 (page 126), we believe that the testing of the accumulation of Universal Life account balances should be more encompassing than just interest accruals, since such accumulation also consists of deposits, withdrawals, charges, and account values released by death.

Section 8.109 (page 127) makes a point that is difficult to over-emphasize, particularly given the wide range of assets in the current market. We note, however, that problems associated with reaching for yield are not limited to credit risk. For example, implicit or explicit option risk and duration mismatch are also potential problems.

In Section 10.13 (page 160) and elsewhere in the Guide, the qualifications for classifying expenses as either acquisition or maintenance (important for SFAS 97) seem to us to be erroneously restrictive. The facts and circumstances of an insurer's business and the anticipated economics of the product vary significantly by company and, thus, we believe this paragraph should be qualified sufficiently so as not to be inappropriately prescriptive. Section 10.68 (page 173) appears to us to take a better approach, and we suggest that it be cross-referenced in this section.

Section 10.26 (page 163) appears to us to be an appropriate place to address an important issue that, to our knowledge, is not mentioned elsewhere in the Guide. We believe that guidance is needed as to the determination of deferrable commissions versus ultimate level commissions when we are dealing with flexible premium contracts under which heavy premium attrition is anticipated (such as flexible premium annuities). At the very least, we believe that a facts-and-circumstances comment is warranted.

Under Section 10.41 (page 166), we believe that the description of loss recognition testing should mention that present values are performed at the earned interest rate, as opposed to the credited interest rate. This is important for SFAS 97 business, where use of the credited interest rate is used for the DAC amortization process. We also believe that the reader should be referred to the guidance in Practice Bulletin 8, or that such language should be transferred to the Guide.

Section 10.65 (page 173) is not inaccurate. However, it may be useful to specifically state that ability to collect is a valuation issue when recording agent debit balances for GAAP purposes.

We observe that pages 237-246 of the Guide (which deal with reinsurance) do not mention the applicable statutory regulatory environment, which we consider to be extremely important. We are particularly concerned that this part of the Guide does not address the model regulation that deals with reserve credit recognition. We recommend that appropriate language be added to this portion of the Guide.

Appendix A (page 332) includes the Academy on a list of "Trade Associations and Institutions." We are uncomfortable with this characterization because the Academy is a *professional* association. We request that the list be retitled as "Trade Associations, Professional Associations and Institutions" to correctly describe the Academy.

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Finally, we have some concerns about the Glossary's definition of "actuary" (page 364). In order to ensure that an actuary will be held to appropriate standards of conduct, practice and qualification, we believe it is appropriate to define an "actuary," and particularly a "qualified actuary," as a member of the American Academy of Actuaries. We note that the Government Accounting Standards Board, the National Association of Insurance Commissioners and others have recognized Academy membership as the hallmark of actuarial professionalism, and recommend that AICPA do so as well. Please be aware, too, that it is the Academy, and not the Actuarial Standards Board, that is responsible for promulgating the *Qualification Standards for Prescribed Statements of Actuarial Opinion* that bind Academy members.

Conclusion

The Financial Reporting Council appreciates this opportunity to comment on the Guide, and hopes that its observations will prove useful. We would welcome the opportunity to provide any further analysis or drafting assistance that the AICPA might find helpful or to discuss its comments with appropriate AICPA representatives. If you require additional information or assistance, please contact Financial Reporting Council Chairperson Lawrence A. Johansen or Academy staff members John H. Trout, Lauren M. Bloom or Ali Arouri at (202) 223-8196. Thank you.

appendix one – examples

Section 1.55 addresses the Tax Reform Act of 1986, and Section 1.56 references the 1988 Tax Act. We recommend that another section be added between what are currently Sections 1.55 and 1.56 that would mention that the 1987 Revenue Act was the first statute to create a requirement bringing many tax reserves below minimum statutory reserves by means of the initiation of the Applicable Federal Interest Rate.

Section 2.3 (page 14) addresses participating or non-participating classification, but non-participating contracts with non-guaranteed elements are not mentioned. Life insurance with non-guaranteed elements actually constitutes the great majority of cash value individual life and annuity business currently sold. Additionally, paid up additions are mentioned as the only non-cash dividend option, omitting term additions. We suggest that this section be clarified.

We also suggest that Section 2.4 (page 14) should mention Group Universal Life and Group Variable Universal Life, both of which are currently far more popular than Group Permanent Insurance.

Section 4.6 (page 37) sets forth a list of indicators of interest-rate risk (C-3 risk). We suggest that this list also include: "Significant long-term liabilities (such as structured settlements), supported by assets with significant debtor optionality (such as residential mortgage backed securities)."

Similarly, Section 4.7 sets forth a list of indicators of business risk (C-4 risk) exposure. We recommend that the list be expanded to include:

- Policyholder taxation (e.g., Internal Revenue Code § 7702) exposure; and
- Litigation exposure (e.g., market conduct).

Section 6.4 (page 77) sets forth lists of standing data and transaction data. These lists appear to cover only traditional life insurance. We suggest expanding the lists to include other forms of insurance. For example, standing data for Universal Life insurance might include:

- Face Amount Option: A (level death benefit) or B(level amount at risk);
- Short-term interest and mortality guarantees.

Figure 7.1 (page 86) sets out a flow chart for the contract classification decision process. We believe that the chart does not classify some forms of deferred annuities appropriately, and that it would be preferable to add to the flow chart an additional classification for deferred annuities with significant sources of profit other than interest rate spread (e.g., surrender charges).

We found Exhibit 7.1 (page 99) to be somewhat difficult to read. We suggest that the numbers in the exhibit be right-adjusted.

Section 8.8 (page 107) refers to testing done by the actuary. This testing procedure is commonly referred to within the actuarial profession as "cash flow testing" or "asset adequacy analysis," a fact that might warrant mention here.

Section 8.15(b) (page 109) addresses modified or full premium term method. It might be beneficial to mention here that full preliminary term may be on a one-year or two-year basis. The two-year basis is used primarily for health coverage. We would therefore suggest that a final sentence be added to this section to state that "the two-year full preliminary term method is allowed for certain health products."

Section 8.20 (page 110) does not appear to recognize allowances made for health insurance. A final sentence should be added to the this section stating that, for certain health products, estimated future voluntary termination or total termination assumptions are specifically allowed.

In Section 8.24 (page 111), with the sentence beginning, "For universal life-type contracts...," we recommend that some mention be made of the NAIC Actuarial Guidelines and Model Regulations as interpretive of the Standard Valuation Law. We invite your reference to Guideline IV and to NAIC Model Regulation XXX (currently pending in most states).

We also believe that the same sentence's explanation of Universal Life reserving methodology could be improved. We suggest that a "building block" structure be used, perhaps as follows:

> The Standard Valuation Law (SVL) defines CRVM for life insurance contracts. Due to the complexity of such contracts and the ambiguity of how to apply the CRVM requirements as stipulated in the SVL to such contracts, further guidance is provided via NAIC model regulations and NAIC Actuarial Guidelines. A qualified actuary is required to interpret these requirements to a company's product.

Please note that the Universal Life Model Regulation and Regulation XXX both interpret (and arguably modify) the reserving rules for Universal Life products.

Section 8.28 (page 111) does not appear to recognize that level premium products are not the only products that may require active life reserves. The relationship of the contract's morbidity costs and its premium structure dictates the need for active life reserves. In general, a requirement for an active life reserve exists where the timing of benefits lags the timing of premiums. We suggest this point be clarified.

We would also observe, with respect to Section 8.45(b), that future expectations need not necessarily be based on historical experience. Future expectations may also be based on best estimates that include historical experience as a source, with PADs under SFAS 60 but not under SFAS 91, SFAS 97, or SFAS 120. (We note that Section 8.49 appears to state this point better.) We also observe that SAP mortality tables include a PAD.

Section 8.50 (page 115) states that the select period for mortality tables is "usually fifteen years." Please note that the recently issued 85-90 mortality tables have a 25-year select period. Consequently, a more general description of the select period such as "five to twenty-five years" would be more accurate.

Section 8.54 (page 115) singles out interest assumptions, describing them as "subjective" and discussing them in the context of an "inability to forecast the future with certainty." These statements seem a bit strong, and we note that other assumptions may require as much application of actuarial judgment, especially when an insurer is entering a new market or developing a new underwriting classification. We suggest that this section be reconsidered so that the interest rate assumption is not isolated as the only subjective assumption.

Section 8.70 (page 118) does not describe the process used to defer the gain described. This is often accomplished by calculating a "breakeven interest rate." This rate is calculated by finding the interest rate that causes the initial reserve to be equal to the net consideration made (gross premium minus acquisition costs). Thus, the process of deferring the gain at issue often accomplishes the objective of providing provision for adverse deviations, inasmuch as the reserves will be calculated using an interest rate lower than that used to calculate the premium. We suggest this point be clarified.

Section 8.88 (page 121) addresses inherent risk factors. In addition to those factors already identified, it might be useful to include the following problems: floor (or minimum) guaranteed interest rates on contracts with non-guaranteed elements such as universal life and deferred annuity contracts, higher than new investment rates and the potential impairment of ability to realize other actuarial assumptions, such as expense assumptions (relating to the scale of the entity's operation, its efficiency, its ability to meet its marketing objectives, etc.).

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In Section 8.90 (page 122), it might be beneficial to recognize that existing systems may also be inadequate to cope with valuation of existing business, such as the classic example of reserve factor omissions in later durations.

Section 8.105 (page 126) references various factors relating to interest. It may be helpful to include references to other items such as an allowance for credit risk, investment expenses, prepayment rates, etc.

Section 8.110 (page 127) references cash value scales. It may also be helpful to specify expiration of withdrawal penalties as a factor affecting withdrawals.

The charts in Section 9.40 (page 156) generally appear to have the items in each column at the same place if they are related. The second item on this page in the second column is useful, but the important auditing procedure related to it is missing from the third column: "Review prior year's values against actual experience of paid claims in later periods."

Section 10.17 (page 160) may not sufficiently recognize recent advances in communications. In the age of the Internet and other communications tools, it might be preferable to change "Some entities operate on the mail-order plan" to "Some entities use mail and other mass-marketing methods to sell their products."

Section10.25 (page 163) does not appear to us to offer much more guidance than that already provided in SFAS 97. It might be useful, for example, to include some further discussion bifurcating the revision process into its two components: historical and prospective. (In other words, addressing the concept of "truing-up" current period estimates of gross profits with actual historical results as they emerge, versus the concept of "unlocking" prospective assumptions when it appears appropriate to do so.)

Additionally, the second sentence of this section seems to us to require revision. It implies that adjustments should be made first to the DAC asset, then to the assumptions, an implication with which we disagree. We suggest this section be revised to state, "When the original assumptions are revised and if the pattern of the estimated gross profit changes, adjustments are made to the total amortized amount as a result of changes in expected gross profit estimates."

We believe it is important to mention in Section 10.40 (page 166) the order of priority of action when confronted with a potential future loss. For FAS 60 products, the first action should be to remove the PAD's.

Section 10.68 (page 173) appears to us to be appropriate, and more reflective of actual current practice than the statements in some of the prior paragraphs. In particular, the second point would support the allocation of some overhead to SFAS 97 acquisition and maintenance expenses if such allocation reflects the economics of the business.

Section 12.15 (page 241) lists collateralization alternatives. We suggest that this section include a reference to "Funds Withheld."

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appendix two – suggested editorial changes

Section 1.32 (page 6) refers to assumption reinsurance. Outside of insolvency situations, assumption reinsurance is now rare, due to problems of implementation (primarily with respect to requiring individual positive elections). Indemnity reinsurance is currently the predominant form of reinsurance, due to the fact that state regulation tends to make assumption reinsurance impractical. We suggest that this point be added to this section.

Section 2.7 (page 14) sets out a definition of "universal life-type products." We recommend that the definition be revised to indicate that participating contracts under SFAS 120 are specifically excluded from the "universal life-type" category.

The last sentence of Section 2.30 (page 18) appears to us to be incorrect. Dividend options are not supplementary contracts. We recommend that this sentence be deleted.

Section 7.8(b) (page 82) refers to net premium or valuation premium. We believe it would be useful for this section to mention "Reserve Modification Method." This could by done by changing the first sentence of the section to read, "This is the amount of premium used in the calculation of the statutory reserve and would vary by reserve modification method (Net Level, CRVM etc.). See Paragraph 8.15."

Section 7.8(e) (page 83) addresses deferred premium, but seems to us to do so somewhat imprecisely. We suggest that the last sentence of this section be revised to read, "This difference in recording the premium revenue and the corresponding asset requires that the *change* in the loading amount *thereon for the period* be recorded as an expense."

Section 7.8(h) (page 83) defines advance premium; again, we believe the definition is less than ideal. We suggest that the first sentence of this section be revised to read, "These are premiums received by the statement date that have still not reached their due date."

Section 7.19 (page 87) addresses deferred premium amounts. We believe it would do so more clearly if it were amended to read, "As discussed in paragraph 7.8, *statutory* deferred premium amounts are a function of the premium payment assumptions used in calculating the benefit liabilities; accordingly, under GAAP, any deferred benefit premium amounts are netted against the liability for future policy benefits and are not recorded as an asset as is generally the case in statutory accounting. *Likewise, any deferred acquisition expense premium amounts are added to the DAC asset, and not recorded as a separate asset.*"

We would also suggest certain edits to Section 7.20 (page 87). Specifically, we recommend that the first three lines of this section be modified to read, "For universal life-type contracts, premium receipts are not recorded as revenues. Gross premium receipts, net of any front-end loads, are recorded as a *deposit fund* liability. Front end loads are deferred over the life of the contract and recorded as an *unearned revenue* liability. The *deposit fund* liability is ..."

We would suggest that Section 8.1 (page106) be amended to refer to the flow chart in Fig. 7.1 for classification of products. Additionally, the comment, "Life insurance generally contains cash accumulation benefits" may be something of an over-generalization in today's insurance market. We believe that "Life insurance may contain cash accumulation benefits" would be more accurate.

We would also observe that the statement, "The ability to estimate the timing and amount of anticipated future cash flows..." in Section 8.1 does not accurately explain why reserves are less than the face amounts of contracts. Reserves are lower than contract face amounts because the expected cash flows are in the future and, in most cases, future premiums are expected to be paid. The ability to estimate this timing plays a role in quantifying the reserves but is not the primary reason that reserves are less than face amounts.

We found the definition of "liability" in Section 8.2 (page 106) to be unnecessarily technical, although not incorrect. We would suggest that this section's references to the "present value of future benefits" and "expenses less future net premiums" be simplified. Additionally, we recommend that this paragraph include a cross-reference to Section 8.68 or to the prior Chapter 7, where net premium is defined. (Please see our comments on Section 7.13.)

Section 8.10 (page 107) accurately states that the company actuary is not required to be independent. However, it might be useful to state that the actuary is required by law to be appointed by the entity's board of directors and that the actuary reports directly to the board in the capacity of appointed actuary.

Section 8.13(b) (page 108) states that, "Mid-terminal reserves assume that half the year's premium has been collected." It might be more precise to state that, "Mid-terminal reserves assume that there are no unearned premiums outstanding as of the valuation date where policyholders have prepaid coverage. It also assumes that on average, the valuation date is halfway between policyholders' policy anniversaries."

Section 8.19 (page 110) could be more precise in addressing maximum valuation interest rates. We suggest that the third sentence be modified as follows: " Maximum valuation interest rates vary by duration of guarantee period and issue date for life insurance. Maximum valuation interest rates vary by issue date (or date of fund change), guarantee period, and contract type for

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annuities."
Section 8.22 (page 110) refers to a requirement for life insurance accounting. We therefore suggest that, in the last sentence of this section , the word "life" be inserted before "insurance contracts."

We found subsection (b) of Section 8.26 (page 111) to be somewhat unclear. We suggest it be reversed in structure to read, "an active life reserve (similar to reserves for life insurance contracts) for noncancellable or guaranteed renewable contracts ...". This restructuring would make subsection (b) consistent with subsections (a) and (c) of this section.

Both Sections 8.29 (page 111) and 8.30 (page 112) are not entirely clear in explaining that a " claim reserve" is for amounts that are not yet due but will become due in the future because of a claim that has been incurred. By contrast, a "claim liability" is for an amount currently due and payable. We suggest this distinction be clarified.

We believe that Section 8.32 (page 112) would benefit from significant expansion, borrowing some structure from our comments on Section 8.24. CARVM is very complex and has been significantly interpreted through the NAIC Actuarial Guidelines. Here again, we believe that interpretation by a qualified actuary is in order.

We also believe that Section 8.35 (page 112) would benefit from a slight expansion. Specifically, it would be preferable if this section were to specify that reserves for supplementary contracts with life contingencies are calculated like reserves for "annuities in a payout phase" rather than just for "annuities."

In Section 8.36 (page 112), we question whether there should be a comment on indeterminate premium products in relation to deficiency reserves (i.e., that the guaranteed premium can be used). Additionally, we suggest that the first sentence of this section be reworded to insert " minimum" in front of " statutory net valuation premium." We would also, in the last sentence, insert "minimum" immediately before "statutory reserves."

It appears that Section 8.48 (page 115) combines two issues: *reasonableness* of assumptions and *adequacy* of GAAP net liabilities. To clarify this section, it might be beneficial to use language along the following lines:

> In determining the collective adequacy of GAAP net liabilities (generally benefit reserve minus deferred acquisition cost) by line of business, the adequacy of the gross premium must be considered. If the GAAP valuation premium (the premium necessary to fund contract benefits and expenses) exceeds the

> actual gross premium charged, a gross premium deficiency may be indicated and future losses may be expected under the contract. If so, the recognition of these losses should be accelerated and recognized in the current period.

We note that Section 8.62 (page 116) relates to this point and seems to us to be more complete.

We also question whether the Guide should contain a definition of "line of business." SFAS 60 refers to "line of business" as the "level of aggregation" at which such testing must be performed. It defines line of business criteria as a common "method of acquisition, method of servicing, and measurement of profit." It might be worthwhile to incorporate that definition into the Guide.

As a general matter, we suggest that Sections 8.49 (page 115) through 8.56 (page 116) should all refer to a provision for adverse deviation on assumptions when dealing with SFAS 60 contracts.

Section 8.67 (page 118) could be phrased more precisely if the last sentence were revised to state, "These liabilities are usually set equal to the corresponding statutory amounts."

In Section 8.68 (page 118), we again suggest that claim reserves should be recognized as separate and distinct from claim liabilities for statutory purposes, even though they are often calculated as one aggregate number for certain lines of business.

Subparagraph 4 of Section 8.95 (page 125) accurately defines contract benefit liability. However, it may be helpful to add that the contract benefit liability is zero at time of issue, unless, of course, there are premium deficiency issues that need to be addressed. It may also be useful to note that the GAAP benefit reserves may be negative, and that companies may hold separate benefit and maintenance expense reserves.

In Section 8.98 (page 125), we suggest that the third sentence end, "... called cash flow testing."

Section 8.111 (page 127) refers to "organizations such as Linton" (we believe LIMRA was intended, and should at least be added). We believe it would be more inclusive to refer instead to " professional or industry organizations," and to then add to this section a second sentence that says, "The Linton tables are examples of published tables."

Section 8.112 (page 127) addresses termination experience. We observe that a conservative PAD for withdrawals may reduce the withdrawal rate rather than increase it, and suggest that the determination of the PAD for withdrawal rates can be complex.

Section 9.7 (page 144) lists various types of immediate annuities. We therefore suggest that the

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first sentence should begin, "The main types of *immediate* annuities are ..."

Section 10.14 (page 160) cross-references Section 24, which does not refer to investment contracts. We therefore suggest deleting "and investment expenses" from the first paragraph of this section.

Section 10.19 (page 161) addresses nondeferrable expenses. We would encourage the AICPA to consider changing "the expense portion of the gross premium" to "the portion of the gross premium attributable to expenses," or "the acquisition expense premium." It also appears that the last sentence of this section was intended to be two sentences. We suggest that a period follow " recognized," and that in the beginning of the next resulting sentence, "Acquisition Costs" replace " cost."

As with Section 10.13, this section seems to us to be inappropriately prescriptive, given the economics associated with the wide variety of products in the market today. We suggest that the AICPA consider an approach that would more properly reflect the flexibility available to insurers to adapt the accounting to the economics of the product.

Section 10.30 (page 164) references "any period" when addressing the alternative basis for DAC amortization. Under current practice, "any period" does not mean one quarter or one year but an extended period. We suggest that this point be clarified. It should be also noted that this requirement applies only to universal life-type contracts.

We believe it might be useful to state in Section 10.39 (page 165) that recoverability or loss recognition is done under best- estimate assumptions (i.e., those without provisions for adverse deviation.) It may also be worth noting that, in determining recoverability, blocks of business may be combined into a line-of-business level of aggregation and overhead expenses removed.

Section 10.47 (page 167) does not, in our view, deal optimally with adjustment for losses. We believe that the last sentence of this section should be replaced with the following language: " Loss recognition testing should be made when future losses first become probable."

We also note that Chapter 12 uses the term "Treaty Reinsurance" to refer to automatic life reinsurance. "Treaty Reinsurance" is a property & casualty term that is not used in the life insurance industry. We suggest that "Automatic Reinsurance" be substituted.

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One Tower Square – 4PB
Hartford, CT 06183-1073
860 277-7499
FAX: 860 954-3708
pauline_c_panik@travelers.com

Paula C. Panik
Vice President
Accounting Policy
Finance

December 28, 1998

Ms. Elaine Lehnert
Technical Manager, Accounting Standards
American Institute of CPAs
1211 Avenue of the Americas
New York, NY 10036-8775

RE:, File 3162.LG

Dear Ms. Lehnert:

Travelers appreciates the opportunity to comment on the exposure draft (ED) of the proposed Audit and Accounting Guide, *Life and Health Insurance Entities* which was released by the Life Insurance Audit Guide Task Force of the Insurance Companies Committee of the AICPA for public comment.

General Concerns:
The National Association of Insurance Commissioners (NAIC) adopted in March 1998 the Codification of Statutory Accounting Principles. The new guidance will become effective January 1, 2001 and will be referred to as the *NAIC Accounting Practices and Procedures Manual – version effective January 1, 2001*. The impact of on this new guidance on the current statutory guidance contained in the proposed audit guide will be significant. In order to effectively convey this pending guidance we propose the following changes to the proposed ED.

Preface

P-7 The National Association of Insurance Commissioners (NAIC) has undertaken a project to codify SAP because the current prescribed-or-permitted statutory accounting model results in practices that may vary widely not only from state to state, but also for insurance entities within a state. The codification is expected to result in a hierarchy of statutory accounting practices that will provide a comprehensive basis of accounting that can be applied consistently to all insurance entities. (See chapter 3 for a discussion of SAP.) ~~This Guide will be updated after the exposure period to reflect the new SAP requirements resulting from the NAIC Codification of Statutory Accounting Principles.~~ In March 1998, The National Association of Insurance Commissioners (NAIC) adopted the Codification of Statutory Accounting Principles. This new guidance will become effective January 1, 2001 and will be referred to as the *NAIC Accounting Practices and Procedures Manual – version effective January 1, 2001*. The impact of this new guidance on the current statutory guidance contained in this audit guide will be significant. Beginning with the effective date of this new guidance (January 1, 2001), the user of this guide should refer to the *NAIC Accounting Practices and Procedures Manual – version effective January 1, 2001* and subsequent versions for the new SAP guidance.

Chapter 1

1.43 NAIC-Codified Statutory Accounting. The NAIC has undertaken a project to codify statutory accounting practices because the current prescribed-or-permitted statutory accounting model results in practices that may vary widely, not only from state to state, but also for insurance entities within a state. The codification is expected to result in a hierarchy of statutory accounting practices that will provide a comprehensive basis of accounting that can be applied consistently to all insurance entities for their financial reporting to regulatory authorities. (See chapter 3 for a discussion of statutory accounting practices.) In March 1998, The National Association of Insurance Commissioners (NAIC) adopted the Codification of Statutory Accounting Principles. This new guidance will become effective January 1, 2001 and will be referred to as the *NAIC Accounting Practices and Procedures Manual – version effective January 1, 2001*. The impact of this new guidance on the statutory guidance contained in this audit guide will be significant. Beginning with the effective date of this new guidance (January 1, 2001), the user of this guide should refer to the *NAIC Accounting Practices and Procedures Manual – version effective January 1, 2001* and subsequent versions for the new SAP guidance.

All Chapters

The statutory guidance contained in each chapter will be superceded upon the effective date of the new guidance (January 1, 2001). This pending event should be clearly stated as a Footnote at the end of each chapter. The SSAPs, within the *NAIC Accounting Practices and Procedures Manual – version effective January 1, 2001*, applicable to the particular chapter topic, should be referenced in the note.

Chapter 1 Example:

Footnotes

In March 1998, The National Association of Insurance Commissioners (NAIC) adopted the Codification of Statutory Accounting Principles. This new guidance will become effective January 1, 2001 and will be referred to as the *NAIC Accounting Practices and Procedures Manual – version effective January 1, 2001*. The impact of this new guidance on the statutory guidance contained in this audit guide will be significant. Beginning with the effective date of this new guidance (January 1, 2001), the user of this guide should refer to the *NAIC Accounting Practices and Procedures Manual – version effective January 1, 2001* and subsequent versions for the new SAP guidance. The following SSAPs within the *NAIC Accounting Practices and Procedures Manual – version effective January 1, 2001* contain statutory guidance applicable to the topics contained in this chapter;

SSAP #1 Preamble – Accounting Practices and Procedures Promulgated by the NAIC
SSAP #35 Guaranty Fund and Other Assessments
SSAP #50 Classifications and Definitions of Insurance Contracts in Force

Specific Comments
In addition to the above general comments we have also provided specific comments by paragraph number which can be found in the attachment to this letter as well as a marked copy of the paragraphs.

* * * * *

We would like to thank the Life Insurance Audit Guide Task Force of the Insurance Companies Committee for the opportunity to comment on this exposure draft. Although we are in agreement as to the need to update the audit guide, we are concerned that the impact on the statutory guidance as a result of adoption of codification be clearly disclosed throughout the document.

We would welcome an opportunity to review these comments with you or answer any questions that you may have. Please feel free to call me.

Sincerely,

Paula C. Panik

Paula C. Panik

COMMENTS

Proposed Audit and Accounting Guide - *Life and Health Insurance Entities*

Paragraph Number	Comments (we have included marked copies for your reference)
1.53	Add: "s' " to policyholder and change "contractholders' " to "policyholders' "
1.55	Add an additional sentence: "This act also repealed the 20 percent special deduction enacted in 1984" to reflect this fact.

* * *

3.10	Add an additional sentence: "The instructions also require insurers to file a supplement to the annual statement titled "Management's Discussion and Analysis" by April 1 each year" to reflect this reporting requirement.
3.13	Add: " 's Annual Statement Instructions" and delete "in all states". The current wording implies the NAIC has authority while the authority rests with the states.
3.14	Add: " ,as adopted by the states, " to reinforce that authority over filing requirements rest with the states. Add an additional sentence: "Also, the insurance departments conduct their own financial examinations of their domestic insurance entities" to indicate this fact.
3.27	Add the following additional language within the paragraph to better explain the purpose of GAAP vs. SAP financial reporting : • "in order to meet the varying needs of the different users of the financial statements" • "to provide" • "are designed to address the concerns of the regulators, who are the primary users of statutory financial statements, and"

* * *

4.2	Replace the word "principle" with "principal" for proper word usage.
4.2.c	Replace the word "matching" with "risk" to be consistent with the other risk descriptions.
4.9	Delete "and any voluntary investment reserves" from the sentence. Voluntary investment reserves were eliminated from Total Adjusted Capital for the 1997 risk-based capital formula.

* * *

5.48 Replace the word "statements" with "report" to correctly reflect the instructions that require an *Audited Financial Report*.

5.91 Add, within bullets 3&5, the word "prescribed or" to reflect the fact that accounting practices may be state prescribed as well as permitted.

Add to the end of the sentence in bullet 3 "of the insurer's state of domicile" to reflect that fact.

11 **General comment**; FAS 130, issued June 1997, requires the Reporting of Comprehensive Income in general-purpose financial statements. A component of which is unrealized gains and losses on available-for-sale securities. FAS 130 paragraph 33 amends certain FAS 115 guidance; for example; *as a net amount in a separate component of shareholders' equity until realized*, was replaced by in *other comprehensive income*. We noted that the new guidance was not incorporated in this chapter. References to unrealized gains and losses on available-for-sale securities in reporting should be ***other comprehensive income***.(Review paragraphs 11.10, 11.13, 11.28, 11.47

11.14 Add the word "qualifying", as this is the correct SAP quidance.

References to the "Valuations of Securities manual" within the paragraph are incorrect and should be the "Purposes and Procedures of the Security Valuation Office manual" (see marked copy).

[Note that throughout this chapter the "Valuations of Securities manual" and the "Purposes and Procedures of the Security Valuation Office manual" are, in many cases, being incorrectly referenced.]

Delete the word "market" and replace the word "rating" with "designation" as this is the appropriate SAP terminology from the SVO manual

11.15 Replace "Valuation of Securities" with "Purposes and Procedures of the Security Valuation Office" which is the correct reference

11.17 Delete the second "unrealized" within the paragraph. To keep it in would incorrectly imply that realized losses are excluded from the IMR and AMR calculations.

11.18 Repurchased agreement should be repurchase agreement. Delete the "d"

11.22 Add the word "instrument" to complete the sentence meaning.

11.27 Replace the reference to the "Valuation of Securities" with "Purposes and Procedures of the Security Valuation Office" which is the correct reference.

11.28 Delete the word "market". It is not SVO terminology

11.29	Replace the NAIC accounting practices and procedures manual reference with "Purposes and Procedures of the Security Valuation Office"
	Replace valuation alternatives (a. through f.) With the direct wording from part 8, section 3, Pages 75-77 of the SVO manual which is the current guidance.
11.30	Replace the reference to "section 4 of the Valuations of Securities" with "part 8 of the Purposes and Procedures of the Security Valuation Office" which is the current guidance.
11.34	FAS 133 guidance needs to be incorporated as indicated in chapter footnote #3.
11.36	Replace the reference to the "Valuation of Securities" with "Purposes and Procedures of the Security Valuation Office" which is the correct reference.
11.77 – 11.81	Discussion should also include LLC's
11.81	Replace the reference to the "Purposes and Procedures of the Security Valuation Office" with "Annual Statement Instructions" which is the correct reference effective 7/1/98.
11.85	Add "or written off" as an allowable option.

* * *

13.4	Change Section reference "842" to "841" in line 4 to reflect the correct reference
13.5	Change "Regulations" to "Code" in line 7 to reflect the correct reference.
13.8b.3.b.1.b	Add qualifying language. Market discount is only accrued currently if the taxpayer makes an election to do so. (The table in 13.31 has the correct language).
13.8b.3.b.2	Add wording to reflect that dividend income is "taxed when received rather than earned".
13.9b	There are four uses of the phrase "statutory basis benefit reserves", in this section, which should be replaced by "tax basis benefit reserves".
13.9b.1	The use of the term "tax basis statutory reserves" is confusing. Although it is presumably used to differentiate from GAAP reserves, it would be clearer to eliminate the word "statutory".
13.10	The editorial comment, "in an effort to increase the tax burden on the life insurance industry," should be deleted.

13.11	The table should specify that premiums for qualified pension plans are not subject to DAC tax. Insert appropriate language.
13.19	The determination of the dividends-received deduction based on the ownership of the dividend paying company is not unique to insurance companies. The reference to "special rules apply to life insurance companies" should be deleted
13.20	The last two sentences are incorrect. The "tentative minimum tax" is generally 20 percent of AMTI. The "AMT" is the excess of "tentative minimum tax" over the regular tax liability.
13.31	The tax accounting section of the table is unclear for investment income. It appears from this section that reserves are decreased by the policyholder's share of all investment income. This is not the case, however. Only tax exempt income reduces the reserves for tax purposes.

* * *

14.7	Other liabilities should include the reference "(including benefit obligations)" The bulleted items listed are intended to represent additional other liabilities that are *unique* to life insurance entities. The employee benefit obligations listed in bullet 4 are not unique to life insurance companies and should therefor be deleted.

Appendix C

C 5	The reference to FAS 119 needs to be updated to reflect that FAS 119 has been superceded by FAS 133.
C 12	Delete this paragraph. The EITF 93-5 guidance contained in this paragraph was nullified by SOP 96-1; paragraph 101 which excludes insurance companies from this requirement.

OTHER

We also noted there was no discussion of "Capital Notes" or "Collateral Loans" within Chapters 11- Investments or Chapter 14 – Other Assets and Liabilities.

1.50 Insurance entities are rated by independent rating agencies for financial strength and claims paying ability. Insurance entity ratings are widely used by sales agents to compare companies, and are important to consumers who are buying insurance policies where claims may not be filed for years, or even decades. Rating agencies base their ratings on financial reports, interviews with company executives and the rating agency's opinion about the entity's business prospects and quality of management. The major rating agencies are Moody's Investors Service (for financial strength), Duff & Phelps (for claims-paying ability), Standard & Poor's (for claims-paying ability), and A.M. Best (for financial strength).

TAXATION

Federal Taxation

1.51 Taxation of U.S. life insurance entities has become increasingly complex. Federal tax policies have a major effect, not only on the profitability of the life insurance industry, but also on product design and the viability of existing products. Paragraphs 1.52 to 1.57 describe the major tax legislation that has affected the life insurance industry and that are discussed further in chapter 13.

1.52 *The Revenue Act of 1921*. This act provided for the taxation of investment income, to the extent that it was not required in the contract reserves to liquidate present and future claims.

1.53 *The Life Insurance Company Act of 1959*. This act continued taxation of the insurance entity's share of investment income, but added taxation of underwriting gains and introduced a complex three-phase tax structure in which taxable income varied according to the relationship of taxable investment income and taxable gain from operations. In certain situations, a portion of otherwise taxable ~~gain from~~ operations was not currently taxed, but was accumulated in a tax basis policyholders surplus account, subject to future tax if distributed, or if ~~contractholders'~~ surplus reached a specified maximum. In determining underwriting gain, a deduction was allowed for the increase in reserves. Tax basis reserves under the 1959 act were generally statutory reserves with an elective adjustment to increase reserves from preliminary term to appropriate net level premium reserve.

policyholders'

1.54 *The Deficit Reduction Act of 1984*. This act replaced the three-phase structure of the Life Insurance Company Act of 1959 with a simplified, single-phase structure. Proration of investment income into the entity's share and contractholder's share was retained. A special deduction was provided equal to 20 percent of otherwise determined taxable income. Tax basis reserves were revised to be calculated using preliminary term methodology and prevailing statutory interest rates and mortality/morbidity tables. The excess of the tax reserves set by the 1959 act over those of the 1984 act were effectively forgiven, in that the excess was not included in taxable income. The 1984 act included a provision to reduce the deductibility of contractholder dividends of mutual entities. A portion of contractholder dividends of mutual entities was viewed as return of equity, somewhat similar to shareholder's dividends of stock life insurance entities. This provision was intended to result in equitable treatment of mutual and stock entities regardless of the differences in their form of ownership. The 1984 act also included a definitional test for life insurance products based on guideline premiums and cash value tests.

1.55 *The Tax Reform Act of 1986*. This act introduced a new alternative minimum tax (AMT) that applies to all corporations, including life insurance entities. The AMT is a second tax calculation that determines the amount of tax a corporation must pay if the AMT exceeds the regular tax calculation. This Act also repealed the 20 percent special deduction enacted in 1984.

1.56 *The 1988 Tax Act*. This act directly affected contractholders, in that contracts afforded tax treatment as life insurance contracts were more narrowly defined. Congress determined that certain contracts that resemble investment vehicles more than life insurance should not be afforded the same tax treatment as life insurance contracts. Under the 1988 tax act, certain classes of life insurance contracts were defined as modified endowment contracts, which alters the taxation of distributions to the contractholder for these contracts prior to death. This provision is applicable to contracts issued after June 20, 1988.

1.57 *The Revenue Reconciliation Act of 1990*. The act passed in 1990 increased the tax burden for life insurance entities by requiring changes in the capitalization and amortization of contract acquisition costs and the treatment of unearned and advanced premiums, that will, in effect, defer certain tax deductions or accelerate taxable income or both.

State Taxation

1.58 State taxation of life insurance entities is usually based on premium revenues received within each taxing authority in which the entity is licensed to write business. Tax rates vary among states, and some states may require the filing of income tax returns by both domestic and foreign insurers. Counties and municipalities may also levy taxes that are generally based on premiums and that are usually collected in lieu of other state income taxes.

STATE GUARANTY FUNDS

1.59 The primary role of the state guaranty system is to provide protection for contractholders in the event that an insurance entity fails. Generally, a state's guaranty laws provide for the indemnification of losses suffered by contractholders through assessments against other solvent insurers licensed to sell insurance in that state. Under the current premium-based system, each insurance entity pays the same assessment rate based on the volume of business written. There are, however, state-by-state limits on the types of insurance and amounts of losses that the guaranty fund will pay. Losses are generally paid by the guaranty fund in the state in which a particular contract was written. In some cases, however, losses are paid in the state in which the contractholder currently resides, regardless of the state of domicile of the underwriter. (See chapter 14 for a further discussion.)

1.60 The National Organization of Life and Health Insurance Guaranty Association (NOLHGA) assists in handling multistate insolvencies, acts as a clearinghouse for information, and provides a forum for resolution of issues and problems arising from the operation of the state guaranty funds.

3.10 states in which the entity writes business. The two most recent calendar years must be presented. In addition, specified supplementary financial data must be provided, including an analysis of operations by line of business (gain and loss exhibit), aggregate reserves for life and accident and health policies (Exhibits 8 and 9 of the *Annual Statement*), detailed schedules of investments (Schedules A to DC of the *Annual Statement*), and various other schedules and exhibits. The NAIC's Annual Statement Instructions require that life insurance entities file, with their *Annual Statement*, an opinion by a qualified actuary regarding the adequacy of reserves and other actuarial items, and their conformity with statutory requirements. (See chapter 5 for additional discussion of the opinion by a qualified actuary.) The instructions also require insurers to file a supplement to the annual statement titled "Management's Discussion and Analysis" by April 1 each year.

3.11 The NAIC has developed several types of *Annual Statement* forms to be used by particular types of life insurance entities and has assigned each a color cover for easy reference, such as the following:

- Life/health insurers (blue)
- Health/medical insurers (brown)
- Variable/separate account insurers (green)

This is only a partial list. The nature of the insurer's business will dictate which *Annual Statement* form is to be filed.

3.12 Software packages are available from the NAIC that produce *Annual Statement* exhibits, schedules, and financial statements based on input information. The NAIC and many state insurance departments now require filing of the *Annual Statement* on a diskette.

's Annual Statement Instructions

3.13 The NAIC *Annual Statement* and forms have been adopted by each state to promote uniformity in reporting, although variations are required by certain states. The NAIC requires life insurance entities ~~in all states~~ to file audited financial statements and a supplemental schedule of assets and liabilities with their state of domicile insurance department. For most states, the audited statutory statements are to be filed as a supplement to the *Annual Statement* on or before June 1 for the year ended December 31, immediately preceding; however, the domiciliary commissioner may request an earlier filing date than June 1 with ninety days advance notice to the life insurance entity. These audit requirements generally apply to life insurance entities writing in excess of a stipulated amount of business or having in excess of a stipulated number of contractholders.

, as adopted by the states,

3.14 In the past, most states, which had adopted laws or regulations requiring independent audits, allowed life insurance entities to file GAAP or consolidated financial statements, or both, provided that the insurance department had granted such approval, and provided that the entity submit specific supplemental SAP/GAAP reconciliations, or separate entity financial statement amounts, or both. More recently, however, the NAIC instructions require the filing of audited statutory-basis financial statements for each individual life insurance entity. These audit rules also require life insurance entities to have their auditors prepare and file a report on significant deficiencies, if any, in the life insurance entity's internal controls, accountant's awareness letter, and an accountant's letter of qualification. (See chapter 5 for further discussion of communications between

3.14

independent auditors and regulators.) In addition to the annual audit requirement, the insurance laws of the various states generally provide the commissioner with the authority to require an independent review or audit of the life insurer's financial condition whenever deemed necessary. Also, the insurance departments conduct their own financial examinations of their domestic insurance entities.

Disclosure Issues

3.15 Financial statements prepared on a SAP basis or any other comprehensive basis of accounting other than GAAP should include all informative disclosures that are appropriate for the basis of accounting used, including a summary of significant accounting policies that discuss the basis of presentation and describe how that basis differs from GAAP. Auditing Interpretation of AU 623, *Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis*, reprinted here as Exhibit 3.1, provides guidance in evaluating whether informative disclosures are reasonably adequate for financial statements prepared on a statutory basis.

GAAP FINANCIAL STATEMENT DISCLOSURES

3.16 Statement on Auditing Standards (SAS) No. 32, *Adequacy of Disclosure in Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 431), requires that sufficient disclosure of material matters be made in order for financial statements to be considered in accordance with GAAP. In addition, SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), requires that an audit be planned and performed in such a manner that the auditor will gain a requisite level of understanding of the entity's business on which to base informed conclusions on the adequacy of financial statement content and disclosures.

3.17 Illustrative GAAP-basis financial statements and related note disclosures typical of life and health insurance companies are included in appendix B. However, financial statement disclosure requirements and practices are continually evolving and are subject to variations of business and materiality for each entity. Life insurance entity specific disclosures are discussed in appendix C. Accordingly, this Guide does not attempt to present all possibilities for disclosure; rather, it attempts to present the auditor with sources and examples of financial statement disclosure that are generally applicable to life insurance entities. GAAP may require additional disclosures such as information concerning related-party transactions, subsequent events, pension plans, postretirement benefits other than pensions, postemployment benefits, lease commitments, accounting changes, off-balance-sheet risks, concentrations of credit risk, fair value of financial instruments, and other matters not unique to life insurance entities. The auditor needs to evaluate the need for disclosure on an entity specific basis.

3.18 Sources of guidance that should be consulted with respect to disclosures specific to life insurance activities follow:

a. FASB Statement No. 60
b. FASB Statement No. 97
c. FASB Statement No. 113
d. FASB Statement No. 120

Mutual Life Insurance Entities

3.24 SOP 95-1 requires entities to disclose the following in the financial statements with respect to participating contracts:

- The methods and assumptions used in estimating the liability for future policy benefits
- The average rate of assumed investment yields used in estimating expected gross margins
- The nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period

SECURITIES AND EXCHANGE COMMISSION REPORTING REQUIREMENTS

3.25 The SEC imposes additional financial reporting rules for stock life insurance entities whose shares are publicly traded on a stock exchange and insurance holding companies. The SEC requires publicly traded entities to file an annual report on Form 10-K, to distribute an annual report to shareholders pursuant to the SEC's proxy rules, and to file quarterly reports on Form 10-Q. Article 7, Insurance Companies, of SEC Regulation S-X governs the form and content of financial statements of life insurance entities included in annual shareholders' reports and filings with the SEC. Both stock life insurance entities and mutual life insurance entities that issue other public securities (e.g., debt) must also comply with certain SEC rules.

TAX-BASIS ACCOUNTING REQUIREMENTS

3.26 Life insurance entities, with the exception of most fraternal societies, are subject to tax, either individually or as part of a consolidated group. Therefore, the IRS influences accounting procedures by requiring special recordkeeping to comply with specific tax laws. Rules and regulations governing accounting methods that are used in the preparation of the income tax returns for a life insurance entity may be different in many respects from SAP and GAAP. These differences are discussed in chapter 13.

COMPARISON OF GAAP AND SAP

in order to meet the varying needs of the different users of financial statements

to provide

3.27 The primary focus of financial reporting in accordance with GAAP is information about earnings and its components. GAAP financial reporting assumes the continuation of an entity as a going concern in the absence of significant information to the contrary. Statutory financial statements emphasize the measurement of ability to pay all current and future contractholder obligations. For example, under SAP, contract acquisition costs are expensed in the period incurred because the funds are no longer available to pay future liabilities. However, under GAAP, in view of the long-term nature of the life insurance contract, these same acquisition costs are capitalized and amortized over varying periods (such as the premium-paying period of the contract) so that expenses and related revenues are recognized in the same accounting period. Table 3.1 presents a summarized comparison of the major difference in accounting treatment between GAAP and SAP for selected financial statement components.

Table 3.1

are designed to address the concerns of the regulators, who are the primary users of statutory financial statements, and.

Chapter 4
Business Risk Considerations

INTRODUCTION

4.1 This chapter is intended to assist the auditor in identifying and assessing the effects of business and economic conditions on inherent risk. In planning the audit of a life insurance entity, the auditor should be aware of the business and economic conditions that affect the industry, and how these conditions affect the entity being audited including the adequacy of the entity's capital.

pal

4.2 Although life insurance entities exist to manage the insurance and investment risks of their contractholders, the ~~principle~~ risks are related to the risk that actual cash flows will be different from anticipated cash flows. Methodologies have been developed to estimate and measure this risk by segregating the elements into four broad categories, C-1 through C-4. These categories are used in the NAIC RBC formulas, which are discussed in paragraph 4.8, to quantify capital requirements for such risks. The categories are as follows:

a. *Asset risk (C-1)*. Also referred to as asset quality risk, this is the risk of asset default or impairment of value. For equity investments such as common stock, equity real estate, and joint ventures, this is the risk of a decline in the value of the investment. For debt investments, such as debt securities and mortgage loans, this is the risk of default, which is defined as failure to make any payment of principal or interest on schedule, or any significant modification in the contract.

b. *Insurance risk (C-2)*. Also referred to as underwriting risk, this is the risk of loss as a result of adverse mortality or morbidity experience and erroneous pricing assumptions other than asset and interest assumptions. This risk covers a wide range of adverse circumstances including unanticipated changes in fixed costs, mortality and morbidity experience, and lapse rates.

risk

c. *Interest rate risk (C-3)*. Also referred to as asset/liability ~~matching~~, this is the risk of loss due to changes in interest rate levels. For example, it may not be possible to find suitable investments with sufficient returns and durations to satisfy the investment earnings assumptions for long-duration contracts common in the industry. Additionally, changes in general interest rates may prompt contractholders to withdraw funds prematurely (referred to as *disintermediation*) or result in prepayment of fixed income securities (referred to as *reinvestment risk*).

d. *Business risk (C-4)*. This is general business and management risk common to

6

- The possibility of large guaranty fund assessments.
- The possibility of federal intervention in the form of nationalized health care that may ultimately change the competitive structure of health insurers.
- Unexpected changes in the individual tax laws, such as those that affected single premium life insurance products and certain types of individual annuities.
- Explosive growth without adequate infrastructure and controls
- Events or transactions that could cause regulators to assume control or supervision of the life insurance entity.
- The possibility of regulatory action to influence or change actions taken by management.
- Downgrading by major rating agencies.

STATUTORY RBC

4.8 The NAIC has developed an RBC program which provides for dynamic surplus formulas (similar to target surplus formulas used by commercial rating agencies). The formulas specify various weighing factors that are applied to financial balances or various levels of activity based on the perceived degree of risk, and are set forth in the RBC instructions. Such formulas focus on the four general types of risk described in paragraph 4.2. The amount of risk determined under such formulas is called the authorized control level risk-based capital (ACLC RBC).

4.9 RBC requirements establish a framework for linking various levels of regulatory corrective action to the relationship of a life insurance entity's *total adjusted capital* (TAC) (equal to statutory capital), plus asset valuation reserve (AVR) ~~and any voluntary investment reserves~~, plus 50 percent of dividend liability, capital notes, and certain other specified adjustments to the calculated ACLC RBC. The levels of regulatory action, the trigger point, and the corrective actions are summarized in Table 4.1.

Table 4.1
Risk-Based Capital Requirements

LEVEL	TRIGGER	CORRECTIVE ACTION
Company action level RBC (CALC)	TAC is less than or equal to 2.0 x ACLC, or TAC is less than or equal to 2.5 x ACLC with negative trend.	The life insurance entity must submit a comprehensive plan to the insurance commissioner.
Regulatory action level RBC (RALC)	TAC is less than or equal to 1.5 x ACLC, or there is an unsatisfactory RBC Plan.	In addition to the action above, the insurance commissioner is required to perform the examination or analysis deemed necessary, and issue a *corrective order*, specifying the corrective actions required.
Authorized control level RBC (ACLC)	TAC is less than or equal to 1.0 x ACLC.	In addition to the actions described above, the insurance commissioner is permitted but not required to place the life insurance entity under regulatory

- Articles of incorporation
- Bylaws
- Chart of accounts
- Organization chart
- Contracts and agreements, such as leases, contract forms, agent contracts, agreements with third parties such as reinsurers, and agreements with affiliated and related organizations
- Description of the internal control, that is, the control environment, the risk assessment, control activities, information and communication, and monitoring
- Loan agreements, bond indentures, and other debt instruments
- Licensing status and examiner's reports

OTHER AUDIT CONSIDERATIONS

5.47 The decision about the appropriate form of audit report to issue in particular circumstances is often derived by a complex judgment that requires considerable professional experience. The auditor may have to communicate with the regulator to assist with his or her assessment. See chapter 15 for illustrative audit reports. Auditors of publicly held life insurance entities should consider the SEC's Financial Reporting Release No. 16, *Rescission of Interpretation Relating to Certification of Financial Statements*, which states, ". . . filings containing accountant's reports that are qualified as a result of questions about the entity's ability to continue existence must contain appropriate and prominent disclosure of the registrant's financial difficulties and viable plans to overcome these difficulties."

Letters for State Insurance Regulators to Comply With the NAIC Model Audit Rule

5.48 The NAIC's *Annual Statement Instructions Requiring* an *Annual Audited Financial* Report ~~*Statements*~~, which incorporates the *January 1991 Model Rule (Regulation) Requiring Annual Audited Financial Reports* (reissued in July 1995) (herein after called the Model Audit Rule) requires auditors to communicate in a certain form and content with state insurance regulators. Though some states have laws or regulations that differ from the Model Audit Rule, this guide addresses only the requirements of the Model Audit Rule. To the extent that the Model Audit Rule is changed in the future, the illustrations in this guide may need to be changed to reflect the revisions.

5.49 Awareness. Section 6 of the Model Audit Rule requires that the insurer notify the insurance commissioner of the state of domicile of the name and address of the insurer's independent certified public accountant (hereinafter referred to as *auditor*). In connection with that notification, the insurer is required to obtain an awareness letter from its auditor stating that the auditor—

a. Is aware of the provisions of the insurance code and the rules and regulations of the insurance department of the state of domicile that relate to accounting and

8

5.91

regulatory bodies.

- Pending changes in the organizational structure, financing arrangements, or other matters that have a material effect on the financial statements of the entity are properly disclosed.

- GAAP financial statements have benefit and claim liabilities, account values, deferred acquisition cost assets, and related financial statement items that are based on appropriate actuarial assumptions and presented in accordance with generally accepted accounting principles.

the prescribed or

- SAP financial statements have ~~aggregate~~ reserves, account values, and related financial statement items that ~~are~~ based on appropriate actuarial assumptions and prepared in accordance with permitted statutory accounting practices. of the insurer's state of domicile.

- Prescribed or ~~P~~ p ermitted practices used in the preparation of the statutory financial statements.

Exhibit 5.1
Illustration of the Accountant's Awareness Letter

To the Board of Directors of ABC Insurance Company:

We have been engaged by ABC Insurance Company (the Company) to perform annual audits in accordance with generally accepted auditing standards of the Company's statutory financial statements. In connection therewith, we acknowledge the following:

We are aware of the provisions relating to the accounting and financial reporting matters in the Insurance Code of *[name of state of domicile]* and the related rules and regulations of the Insurance Department of *[name of state of domicile]* that are applicable to audits of statutory financial statements of insurance enterprises. Also, after completion of our audits, we expect that we will issue our report on the statutory financial statements of ABC Insurance Company as to their conformity with accounting practices prescribed or permitted by the Insurance Department of *[name of state of domicile]*.

The letter is furnished solely for filing with the Insurance Department of *[name of state of domicile]* and other state insurance departments and should not be used for any other purpose.

Exhibit 5.2
Illustration of the Change in Auditor Letter

To the Board of Directors of DEF Insurance Company:

We previously were auditors for DEF Insurance Company and, under the date of [report date], we reported on the statutory financial statements of DEF Insurance Company as of and for the years ended December 31, 19X1 and 19X0[1]. Effective *[date of*

SEC staff believes that, in addition to deferred tax assets and liabilities, registrants should adjust other assets and liabilities that would have been adjusted if the unrealized holding gains and losses from securities classified as available-for-sale actually had been realized. That is, to the extent that unrealized holding gains or losses from securities classified as available-for-sale would result in adjustments of minority interest, policyholder liabilities, deferred acquisition costs that are amortized using the gross-profits method, or amounts representing the present value of future profits that are amortized using the gross-profits method had those gains or losses actually been realized, the SEC staff believes that those balance sheet amounts should be adjusted with corresponding credits or charges reported directly to shareholders' equity. As a practical matter, the staff, at this time, would not extend those adjustments to other accounts such as liabilities for compensation to employees. The adjustments to asset accounts should be accomplished by way of valuation allowances, that would be adjusted at subsequent balance sheet dates.

For example, registrants should adjust minority interest for a portion of the unrealized holding gains and losses from securities classified as available-for-sale if those gains and losses relate to securities that are owned by a less-than-wholly-owned subsidiary whose financial statements are consolidated. Certain policyholder liabilities also should be adjusted to the extent that liabilities exist for insurance policies that, by contract, credit or charge the policyholders for either a portion or all of the realized gains or losses of specific securities classified as available-for-sale. Further, certain asset amounts that are amortized using the gross-profits method, such as deferred acquisition costs accounted for under FASB Statement No. 97, and the present value of future profits recognized as a result of acquisitions of life insurance entities accounted for as purchase business combinations, should be adjusted to reflect the effects that would have been recognized had the unrealized holding gains and losses actually been realized. Further, capitalized acquisition costs associated with insurance contracts covered by FASB Statement No. 60 should not be adjusted for an unrealized holding gain or loss unless a "premium deficiency" would have resulted had the gain or loss actually been realized.

This announcement should not affect reported net income. It addresses only the adjustment of certain assets and liabilities and the reporting of unrealized holding gains and losses from securities classified as available-for-sale.

Purposes and Procedures of the Securities Valuation Office manual

qualifying

11.14 *SAP.* Under SAP, debt securities are carried at amortized cost, subject to the valuation standards of the NAIC, as described in the NAIC's ~~*Valuations of Securities*~~ manual. As with GAAP, amortization or accretion under SAP is calculated by the interest method. Debt securities that do not qualify for

11.14

amortization under the ~~Valuations of Securities~~ manual are carried at the value listed in the manual, referred to as *association value* (made up of two parts: an actual ~~or~~ estimated ~~market~~ price and an NAIC designation, which is a rating for quality), or at book value, whichever is lower. Generally, nonqualifying debt securities are those that are in default or otherwise impaired with regard to principal or interest payments or some other valuation factor. Usually, the life insurance entity does not accrue interest income for debt securities in default or with interest or principal payment ninety days in arrears. Effective for year-end 1998, debt securities not listed in the manual, or obligations listed with no value, require the determination of an acceptable value that can be substantiated to the appropriate NAIC subcommittee or regulatory agency. In the event that a debt security is not listed in the *Valuations of Securities* manual or is listed with no value, the life insurance entity is required to submit sufficient information on these securities to the NAIC Securities Valuation Office for a determination of ~~market~~ value. The security can be held for one year as a non-rated security. After one year, if ~~a rating~~ has not been received by the NAIC Securities Valuation Office, ~~the security~~ must be given a ~~rating~~ designation of 6*.

Valuations of Securities

Unit

11.15 Guidance for accounting for loan-backed and structured securities, including CMOs, is provided in the NAIC's *Accounting Practices and Procedures Manual*. At purchase, loan-backed and structured securities are recorded at purchase cost. Discount or premium is recorded for the difference between the purchase price and the principal amount. The discount or premium is amortized using the interest method and is recorded as an adjustment to investment income. The interest method results in the recognition of a constant rate of return on the investment equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments of book value. Loan-backed and structured securities are subject to the valuation standards of the NAIC as described in the *Accounting Practices and Procedures Manual and ~~Valuations of Securities~~* manual.

11.16 Requirements for carrying debt securities as admitted assets vary at the discretion of the states. A debt security may be classified as a nonadmitted asset to the extent that it fails a qualitative or quantitative limitation test or is otherwise not authorized by the applicable state code.

11.17 Realized and unrealized gains and ~~unrealized~~ losses for assets classified as debt securities are included in the interest maintenance reserve (IMR) and asset valuation reserve (AVR) calculation.

Securities Lending Transactions

11.18 Life insurance entities may also lend debt securities (referred to as "securities lending") or enter into other agreements such as repurchase~~d~~ agreements, reverse repurchase agreements or dollar repurchase and dollar reverse repurchase agreements. These types of transactions are generally short-term in nature, ranging from one to thirty days; however, longer terms are possible. When a debt security is loaned, collateral consisting of cash, cash equivalent, or both is pledged and maintained in an escrow account. If the collateral is cash, the transferor typically earns a return by investing that cash at

11.22 (same issuer). In addition, these transactions often involve mortgage-backed securities (also referred to as *pass-through certificates or mortgage-participation certificates*).

11.23 GAAP. If the criteria in paragraph 9 of FASB Statement No. 125 are met, the transferor should account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee should account for the agreement as a purchase of financial assets and a forward resale commitment. Paragraph 29 of FASB Statement No. 125 states "to be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transfer must at all times during the contract term have obtained cash or collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others."

11.24 Furthermore, wash sales that previously were not recognized if the same financial asset was purchased soon before or after the sale should be accounted for as sales under FASB Statement No. 125. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

Equity Securities

11.25 Equity securities represent units of ownership in a corporation or the right to acquire or dispose of an ownership interest in a corporation at fixed or determinable prices and may include common and nonredeemable preferred stocks, mutual fund shares, warrants, and options to purchase stock. Generally, equity securities generate cash dividends or dividends paid in the form of additional shares of stock. The sale of shares of equity securities usually results in a realized gain or loss.

11.26 GAAP. Under GAAP, equity securities that have readily determinable fair values as defined by FASB Statement No. 115 are classified as either *trading or available-for-sale* securities and reported at fair value. Temporary changes in the fair value of those securities are recognized as unrealized gains and losses and are accounted for as described in paragraph 11.10. Investments in equity securities that are not addressed by FASB Statement No. 115 or do not have readily determinable fair values should be consolidated or accounted for under APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, using the *cost* or *equity* method.

Purposes and Procedures of the Securities Valuation Office

11.27 SAP. Under SAP, equity securities are generally reported at the value published in the *Valuations of Securities* manual, which is the determination of "market" for each listed stock by the NAIC's subcommittee on valuation of securities. Non-redeemable preferred stock are generally carried at cost, subject to the valuation standards of the NAIC as described in the ~~*Valuations of Securities*~~ manual. Common and preferred stocks are also subject to both qualitative and quantitative limitations as defined by the state of domicile to qualify as admitted assets.

11.28 Equity securities not listed in the *Valuations of Securities* manual or listed

11.28 with no value, require the determination of an acceptable value that can be substantiated to the appropriate NAIC subcommittee or regulatory agency. The life insurance entity is required to submit sufficient information on these securities to the NAIC Securities Valuation Office for a determination of ~~market~~ value.

Purposes and Procedures of the Securities Valuation Office manual provides

11.29 Under NAIC rules, investments in the common stock of subsidiaries or affiliates are generally valued on one of the following bases; however, practices and procedures prescribed by the state of domicile may differ. The NAIC ~~*Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies* lists~~ the following alternatives for valuation of equity investments in subsidiaries:

Use SVO WORDING Part 8 Sec 3 Pgs 75-77 (Attached)

a. Statutory capital and surplus value for an insurance subsidiary whose common capital stock is not publicly traded
b. Net worth of a noninsurance subsidiary, adjusted to use only those assets of the subsidiary that would constitute admitted assets if owned directly by an insurance entity
c. Net worth of a noninsurance subsidiary with its value adjusted for restrictions on downstream insurance subsidiary and goodwill assets
d. Cost adjusted to reflect subsequent operating results of the subsidiary with its value adjusted for restrictions on downstream insurance subsidiary and goodwill assets. (Operating results of the noninsurance subsidiary should be in accordance with GAAP, and operating results for an insurance subsidiary should be in accordance with SAP.)
e. Market value for a partially owned subsidiary that is listed and publicly traded on a national securities exchange
f. Any other value that can be substantiated to the satisfaction of the NAIC Subcommittee on Valuation

11.30 In addition to the alternatives listed in paragraph 11.29, ~~when~~ the valuation of noninsurance subsidiaries uses financial information prepared in accordance with GAAP, ~~section 4 of the *Valuations of Securities*~~ manual requires that the subsidiary's financial statements for the most recent fiscal year must be audited by an independent certified public accountant in accordance with generally accepted auditing standards. part 8 of the Purposes and Procedures of the Securities Valuation Office

11.31 Realized and unrealized gains and losses for assets classified as equity securities are included in the AVR calculation (see paragraphs 11.40 through 11.45) in the equity component except for certain preferred stock assets that may be included in the default component.

Futures, Options, and Similar Financial Instruments

11.32 Recent years have seen a growing use of innovative financial instruments, commonly referred to as derivatives, that often are complex and can involve a substantial risk of loss. As interest rates, commodity prices, and other market rates and indices from which certain financial instruments (derivatives) derive their value may be volatile, the fair value of those instruments may fluctuate significantly and entities may experience significant gains or losses because of

SVO Manual

Part Eight: Valuation of Subsidiary, Controlled and Affiliated (SCA) Company Common Stock

Section 1. Value of Common Stock Insurance companies described in Part Four, Section 1(a), shall use one of the methods described in Section 3 below to calculate the value of their common stock investments in insurance and non-insurance SCA companies. Nothing in this Part shall be read as requiring an insurance company to value all of its SCA company common stock pursuant to the same method. However, the valuation method used by a reporting insurance company for a specific SCA company shall be applied consistently. Once selected, the chosen valuation method can only be changed upon notice to and approval of the SVO.

Section 2. Reporting To SVO

(a) General Reporting Instructions Not later than June 1 for existing investments, and within 30 days of the acquisition or formation of a new investment, an insurance company shall calculate the value of its common stock investments in insurance and non-insurance company SCA companies and report the value to the SVO. Reporting an initial filing is accomplished by submitting a completed SUB 1 form for each investment, disclosing (i) the valuation reported or to be reported by the insurance company on its latest or next quarterly NAIC Financial Statement Blank, (ii) which method of those described in Section 3 below was used to arrive at the valuation, (iii) the factual context of the transaction and (iv) economic and business motivations for the transaction. The submission will be processed by the SVO only if the SVO determines it has been provided with all material information with respect to all SCA companies of the reporting insurance company that require valuation.

(b) Special Instruction - Book Value of Insurer's Common Stock No filing of an investment in the common stock of an SCA company valued pursuant to Section 3 (c) shall be made with the SVO after January 1, 1999. Insurers who select the Section 3 (c) valuation method to value an investment of common stock of an SCA company after January 1, 1999 shall continue to apply the methodology and rules of Section 3 (c) of this Part to such valuations. The calculations made in support of such valuations and the rationale employed to address other relevant issues under Section 3 (c) shall be retained for the benefit of state insurance examiners.

Not later than June 1 for existing investments, and within 30 days of the acquisition or formation of a new investment, an insurance company shall calculate the value of its common stock investments in insurance and non-insurance company SCA companies and report the value to the SVO. Reporting an initial filing is accomplished by submitting a completed SUB 1 form for each investment, disclosing (i) the valuation reported or to be reported by the insurance company on its latest or next quarterly NAIC Financial Statement Blank, (ii) which method of those described in Section 3 below was used to arrive at the valuation, (iii) the factual context of the transaction and (iv) economic and business motivations for the transaction. The submission will be processed by the SVO only if the SVO determines it has been provided with all material information with respect to all SCA companies of the reporting insurance company that require valuation.

Section 3. Valuation Methods In fulfilling the requirements of Sections 1 and 2 above, insurance companies may use any of the following valuation methods:

(a) Admitted Asset Equivalent Pursuant to this method, which may only be used for non-insurance SCA companies, the value of the common stock is limited to the value of those assets of the SCA company that would constitute lawful investments for the insurance company, if acquired or held directly by the insurance company. This is the sole valuation method that permits submission and use of an unaudited financial statement.

(b) GAAP Net Worth; Adjusted GAAP Net Worth Pursuant to the GAAP Net Worth method, the value of the common stock of a non-insurance company is determined by reference to the company's GAAP net worth at fiscal year-end determined on the basis of Audited Financial Statements prepared by an independent certified public accountant in accordance with generally accepted auditing standards. Under Adjusted GAAP Net Worth, the common stock of a company is valued on the basis of GAAP net worth, adjusted to reflect equity in net assets on a statutory basis for the shares of any underlying insurance company and adjusted to reflect discounted market value for any company valued under the Market Value method discussed in Section 3(e) of this Part. Both methods require the insurance company to follow the procedures discussed in Section 4(b)(ii) of this Part.

(c) Book Value of Insurer's Common Stock Pursuant to this method, the value of the common stock of an insurance company is derived by reference to the insurance company's book value, calculated by dividing the company's NAIC Financial Statement Blank capital and surplus, less the value of its preferred stock and surplus notes, by the number of shares of its issued and outstanding common stock. The insurance company is required to submit the NAIC Financial Statement Blank to the SVO. A non-insurance company may not use this valuation method.

(d) At Cost Adjusted For Operating Result Under this method, the value of the common stock of a company is derived by reference to the cost of the common stock of an SCA company, after deduction for goodwill and other intangibles, and adjustments for subsequent operating results. Value is presented in accordance with statutory accounting principles for insurance companies and in accordance with GAAP based on Audited Financial Statements prepared by an independent certified public accountant for all other companies. For non-insurance companies, adjustments for subsequent operating results shall include net changes in all the capital and surplus accounts on a statutory basis for the shares of any insurance company subsidiary. This method requires the insurance company to follow the procedures discussed in Section 4(b)(ii) of this Part.

(e) Market Value Pursuant to this method, the value of the common stock of a company is derived by reference to the market value of the stock, provided the stock is listed on a U.S. national securities exchange or entered in the NASDAQ National Market System, discounted for size and depth of the market and, in the case of restricted common stock, for legal restrictions on transferability. Over-the-counter securities will not be valued under this section. The use of this method requires the reporting insurance company to obtain the discount rate to be applied to its common stock from the Manager of the Subsidiaries Group of the SVO.

(f) Preferred Stock of SCA Companies The value of the preferred stock of a wholly owned subsidiary of an insurance company is derived by reference to any of the methods appropriate for determining the value of the preferred stock of a subsidiary discussed in Part Six, Sections 2(b)(i) and 3, if applicable.

(g) **Foreign Subsidiary** Pursuant to this provision, insurance companies may apply the Admitted Asset Equivalent method discussed in Section 3(a) above to insurance companies organized in foreign countries. The basis for the calculation of value will be the financial statements of that insurance company for the most recent fiscal year, prepared by an independent certified public accountant.

Section 4. SVO Assessment and Review Upon receipt of the reporting insurance company's SUB 1 filing, the staff shall conduct an assessment in the following manner:

(a) **Assess Transaction** As a first step, the staff shall review the factual, business and economic context of the transaction to determine whether (i) the transaction in which the shares of common stock were purchased or otherwise transferred appears to be an arms-length business arrangement with a reasonable economic value to the reporting insurance company, (ii) the valuation method chosen is reasonable in view of the factual, business and economic context of the transaction, (iii) the transaction is reasonable in the context of all the known facts surrounding the insurance company and its operations and (iv) the value reported appropriately reflects economic value to the insurance company. The staff may consider other factors that appear relevant from the context of the transaction including:

(i) The specific tax, accounting or other regulatory treatment sought;

(ii) Whether the transaction effects a legally effective, binding and permanent transfer of the risks and rewards of ownership;

(iii) The effect of the subsidiary valuation on the solvency of the insurer;

(iv) The degree of affiliation between the insurer and the party from whom such company was acquired, the form of the consideration (cash, property or the exchange of stock), evidence of ability to recover cost and whether the acquisition price represented the result of arms-length dealing between economic equals;

(v) The right to dividends or other payments from the subsidiary and any limitations thereto;

(vi) The nature, extent and demonstrable financial value of the business operations of the subsidiary; and

(vii) The value of the assets owned by the subsidiary.

If the staff determines that the transaction does not seem to present economic value to the insurance company, or that the transaction tends to obscure issues that might be relevant to an NAIC Member or that the information provided is insufficient or unreliable as a basis upon which to make a their use. With the introduction of interest-sensitive products and the globalization of markets, life insurance entities increasingly use interest-rate futures contracts, options, interest-rate swaps, foreign currency options, and other similar derivative financial instruments to manage and reduce risks related to market changes in interest rates and foreign currency exchange rates. Financial transactions entered for purposes of minimizing price or interest rate risk are called hedges.

11.33 Options and futures contracts can also be entered into for speculative purposes, but most insurance regulators prohibit life insurance entities from these types of speculative transactions. Although the criteria to qualify for hedging transactions may differ from state to state, at a minimum the item to be hedged must expose the life insurance entity to price, interest-rate, or currency exchange risk, and the financial instrument used as a hedge must reduce the specific risk exposure.

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11.34 _GAAP_. Under GAAP, to the extent derivatives are financial instruments as defined in FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*; the disclosure requirements set forth in FASB Statements No. 105, No. 107, *Disclosures about Fair Value of Financial Instruments*; and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, must be met. Other accounting and reporting requirements for derivative financial instruments are included in FASB Statements No. 52, *Foreign Currency Translation*, and No. 80, *Accounting for Futures Contracts*, as well as a variety of FASB EITF Consensuses including but not limited to No. 84-7, *Termination of Interest-Rate Swaps*; No. 84-14, *Deferred Interest Rate Setting*; No. 84-36, *Interest Rate Swap Transactions*; No. 86-34, *Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions*; No. 87-26, *Hedging Foreign Currency Exposure with a Tandem Currency*; No. 90-17, *Hedging Foreign Currency Risks with Purchased Options*; No. 91-1, *Hedging Intercompany Foreign Currency Risks*; No. 91-4, *Hedging Foreign Currency Risks with Complex Options and Similar Transactions*; No. 96-13, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled In, a Company's Own Stock*.

11.35 The AICPA publication *Derivatives–Current Accounting and Auditing Literature* summarizes current authoritative accounting and auditing guidance and provides background information on basic derivative contracts, risks, and other general considerations.

11.36 _SAP_. Under SAP, options and futures contracts are generally classified as other admitted assets, and the types of contracts that are permitted, accounting considerations, investment limits, and many other factors may differ from state to state. Gains and losses are either deferred, recognized, or used to adjust the basis of the hedged item. State regulations and directives, and the NAIC's *Accounting Practices and Procedures* manual and ~~*Valuations of Securities*~~ manual provide guidance on statutory accounting practices. Purposes and Procedures of the Securities Valuation Office

11.37 Generally, for assets carried at amortized cost, any gain or loss on options accounting treatment, and income recognition. It is not uncommon to find transactions between the life insurance entity and the venture or partnership that may affect the carrying value and income recognition of other investments such as mortgage loans and debt securities. Joint ventures generally remit dividends to venture partners, and may result in a gain or loss upon disposal of their interest in the venture or partnership. In many cases life insurance entities do not take an active role in the management of the venture.

11.79 _GAAP_. Under GAAP, the ownership percentage in and the degree of control over the joint venture or partnership determine whether the cost, equity, or consolidation method applies with respect to the accounting and reporting of the investment. Many of the standards for the accounting and reporting of joint venture investments are established in SOP 78-9; APB Opinion 18; FASB Statement No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*; and FASB Statement No. 94. The life insurance entity should disclose any contingent obligations or commitments for additional funding or guarantees of obligations of the investee in the notes to the financial statements. In addition, consensuses of the FASB's EITF provide guidance on various matters affecting investments in joint ventures and partnerships.

11.80 _SAP_. Under SAP, these types of investments are generally reported as other invested assets accounted for under the equity method. In addition, it may also be necessary to account for capital gains, return of capital, and dividends.

11.81 Any realized gains or losses and unrealized losses are recognized as a component of net income after net gain from operations and included in the calculation of the AVR reserve in the equity component under the real estate and other invested assets subcomponent. The NAIC's ~~*Purposes and Procedures of the Securities Valuation Office*~~ should be referred to for specific guidance on the AVR.

Annual Statement Instructions (effective 7/1/98)

Policy Loans

11.82 Policy loans are loans made to contractholders using their life insurance contract's cash value as collateral. There are no statutory restrictions applied to this type of investment other than that the loan taken by contractholders may not exceed the cash surrender value of the policy. In addition, the loan interest rate is regulated in most states. If the contractholder stops paying premiums after a policy loan equals the surrender value, the contract is terminated.

11.83 Many whole life contracts carry automatic policy loan provisions that allow for automatic policy loans from cash values to pay scheduled premium payments. For universal life-type contracts the cost of insurance and other charges paid from cash values are not considered policy loans.

11.84 Policy loans are unique to life insurance entities and are carried on the balance sheet at the unpaid principal balance plus accrued interest under SAP. This practice is commonly used for GAAP.

INVESTMENT INCOME DUE AND ACCRUED

11.85 *Investment income due* represents certain amounts of income which are legally owed to the company as of the statement date but have not yet been received. Investment income should not be accrued if collectibility is doubtful. For statutory purposes, these uncollectible amounts should be treated as nonadmitted. or written off

11.86 *Accrued investment income* represents interest that would be collectible if the obligation were to mature as of the statement date. The amounts that are shown as accrued for preferred stocks and common stocks are dividends on stocks declared to be ex-dividend on or prior to the statement date and payable after that date.

AUDITING

Debt and Equity Securities

11.87 SAS No. 81, *Auditing Investments*, which supersedes SAS No. 1, section 332, *Long-Term Investments*, and deletes Interpretation No. 1 of SAS No. 1, section 332, "Evidential Matter for the Carrying Amount of Marketable Securities," provides guidance to auditors in auditing investments in debt securities and equity securities as defined in FASB Statement No. 115 and investments accounted for under APB Opinion No. 18. SAS No. 81 is effective for audits of financial statements for periods ending on or after December 15, 1997. Early application is permissible.

Inherent Risk

11.88 In assessing audit risk, the auditor should consider those factors influencing inherent risk related to investments, including factors relating to management, investment operations, and portfolio characteristics. Such factors might encompass the following.

<u>Investments in General</u>

- The entity's general investment policy is very aggressive and encourages the use of new and innovative types of securities or other investment vehicles that are susceptible to investment valuation adjustments.
- The types of investments, length to maturity, rates of return, and other investment strategies are not well matched to the type of products sold or the cash flow needs of the entity.
- Changing regulations, including those concerning related-party transactions, current tax rules, and reporting requirements, may establish specific practices allowed in the valuation and diversification of an investment portfolio.
- Investments are concentrated either by certain types (for example, high-yield securities), issues (for example, specific industry bonds), geographical areas (for example, regional concentrations of mortgage loans or real estate projects), or single issuer.
- There is a high concentration of investments in securities subject to

Chapter 13
Taxation of Life Insurance Entities

previous next

INTRODUCTION

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Federal Income Taxes

13.1 In general, life insurance entities are subject to the same federal income tax laws that apply to other commercial entities. There are, however, additional sections of the Internal Revenue Code (IRC or "the Code") and related Treasury regulations that apply specifically to life insurance entities. Sections 801-818 and 842-848 of the IRC applies to all business entities that meet the definition of a *life insurance company* as described in paragraph 13.3. This chapter is intended to familiarize the reader with significant and unique features of life insurance taxation.

13.2 The taxation of life insurance entities has changed substantially as the result of a series of tax law changes enacted since 1984. From 1958 to 1983, life insurance companies, as defined by the IRC, were taxed under the Life Insurance Company Income Tax Act, which prescribed a complex three-phase structure. The Deficit Reduction Act of 1984 eliminated the three-phase taxation structure of the 1959 Code and mandated a simpler single-phase system based on total *life insurance company taxable income* (LICTI). Under the 1984 act, life insurance companies are taxed on all sources of income at ordinary corporate tax rates. The 1984 act was modified in 1986 and again in 1990; however, the single phase system has been retained. Although the three-phase taxation structure has been eliminated, the phase *III income tax*, as discussed in paragraph 13.18, remains from the prior law for many stock life companies.

13.3 Definition of a "Life Insurance Company" for Federal Income Tax Purposes. For a life insurance entity to be taxed as a *life insurance company*, by Internal Revenue Code definition it must meet the following requirements on an annual basis:

1. More than half of its business activity during the year is the issuing of life insurance or annuity contracts or the reinsuring of such risks underwritten by other insurance companies; and
2. The company's life insurance statutory reserves, plus unearned premiums and unpaid losses on noncancellable life, accident or health policies not included in life insurance tax basis reserves, must comprise more than 50% of its total statutory reserves.

As a result, entities that are organized as life insurance companies under applicable state insurance laws may not qualify as *life insurance companies* for federal income tax purposes. For purposes of this chapter, the term *life insurance company* is used as defined above. In addition, other terms referred to in this chapter may have unique meaning under the IRC.

ELECTION TO FILE A CONSOLIDATED RETURN

13.4 For taxable years beginning after December 31, 1980, the common parent of an affiliated group that has one or more life insurance companies may elect to treat such companies as includable corporations and include them in the filing of a consolidated return. The election must apply to all life insurance companies that otherwise qualify as members of the affiliated group. Once the election is made, the group must continue to file consolidated returns unless the group obtains permission from the commissioner of the IRS to revoke its election. If the election is not made, the life insurance companies will continue to be treated as nonincludable corporations; however, two or more life insurance companies may elect to file a consolidated return with each other provided the requisite 80% stock ownership test of the IRC is satisfied.

Five-Year Affiliation Requirement

13.5 A life insurance company cannot be treated as an includable corporation in a consolidated return with nonlife companies unless it has been a member of the affiliated group for the five taxable years of the common parent entity immediately preceding the taxable year for which the consolidated return is filed. The term *eligible corporation* is defined by the IRC as a corporation (life or nonlife) that has satisfied the various tests of the five-year requirement (see Section 1504 (c)(2)(A) of the Internal Revenue ~~Regulations~~ Code). An ineligible life insurance company may not be included; however, if an ineligible nonlife insurance company is includable in the consolidated group, its losses may not reduce the income of the life members. If the ineligible life insurance company is also the parent of the group, the life-nonlife consolidated return election cannot be made.

13.6 Consolidation rules for life and nonlife consolidated tax returns are complex, and the auditor should consider retaining the services of life insurance tax specialist for advice in these matters.

ELEMENTS OF LIFE INSURANCE COMPANY TAXABLE INCOME

13.7 The following discussion of the elements of LICTI focuses on the elements of statutory gain from operations as adjusted to arrive at taxable income. LICTI tends to follow statutory accounting practices rather than generally accepted accounting principles.

Life Insurance Gross Income

13.8 Life insurance gross income consists of all of the items of income earned by the life insurance company, both in its underwriting and investment capacities. The elements of income are gross premium income, decrease in tax basis reserves, gross investment income, net capital gains, and other amounts. Components of life insurance gross income are as follows.

 See Table 13.31

13.8 b

discount. (Taxpayer has option to elect and not to accrue market discount currently)

c. Original issue discount (OID).

2. Dividend income, taxed when received rather than earned.

3. Rental income. Adjustments may be necessary for rents received in advance. In addition, the Annual Statement may include charges for occupying company-owned real estate (referred to as imputed rent). These amounts should be reversed for tax purposes.

4. Royalty income.

5. Leases, mortgages and other instruments. Various timing differences exist with respect to the recognition of income relating to mortgages and leases. In addition, there are timing differences relating to the write-offs of nonperforming leases and mortgages. Generally, for tax purposes, write-offs are deductible only on a specific write-off method where worthlessness can be demonstrated (as defined by the IRC).

6. Capital gains and losses.

7. Wash sales.

c. Other amounts included in gross income. This category would include all other amounts of income that are not reportable as part of premium or investment income. An example of this would be ordinary gains derived from the sale of assets used primarily in trade or business (for example, computers, furniture, and section 1231 assets), or income from nonlife trade or business. An analysis should be made of all miscellaneous income items of the company.

Life Insurance Company Deductions Allowed

13.9 The Annual Statement deductions are generally allowed for tax purposes, subject to tax modifications (for example, calculation of life insurance tax basis reserves and discounting of certain other statutory reserves). In addition to the deductions appearing on the Annual Statement, special deductions, such as the dividends- received deduction (DRD) and the operations loss deduction (OLD), are generally available. The following are deductions allowed for life insurance companies:

a. *Death benefits*. Payments to contractholders under insurance contracts (for example, death benefits and annuity benefits) are generally deductible. In addition, incurred but not reported (IBNR) liabilities represent matured liabilities that for tax purposes should no longer be a part of life insurance tax basis reserves as these amounts represent future unaccrued claims. Therefore, reasonably estimated IBNR liabilities as of the end of the taxable year should be included in the death benefits deduction. Corresponding IBNR adjustments should be made to the life insurance statutory benefit reserves.

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income. Congress concluded that life insurance companies receive a double benefit through an increase in reserves that may be partially funded by tax-exempt interests and dividends or both, and introduced the proration mechanism into the tax law. The proration mechanism requires that a portion of the tax-exempt interest and dividend received deduction be added back to taxable income.

d. *Policyholder dividends.* For tax purposes, the term policyholder dividends is broadly defined as a dividend or similar distribution to contractholders in their capacity as such, regardless of whether the contract is participating or not. Policyholder dividends may include: (a) amounts paid or credited (including an increase in benefits) where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management, (b) premium adjustments, (c) excess interest, and (d) experience-rated refunds.

   Life insurance companies are entitled to deduct policyholder dividends paid or accrued during the taxable year. The liability for policyholder dividends is not taken into account in determining the deduction. Policyholder dividends are defined by the Code, as described above, and may include amounts that are not treated as policyholder dividends under statutory accounting rules, and may apply to nonparticipating contracts. For mutual insurance companies, the amount of policyholder dividends deduction is reduced by the differential earnings amount (see paragraph 13.14 for discussion).

e. *Other deductions.* Life insurance companies are allowed deductions generally available to other nonlife companies. Almost all general insurance expenses, including those listed in exhibits 5 and 6 of the Annual Statement, are deductible as other deductions. The following limitations and adjustments should apply to certain deductions:

   1. No deduction is allowed for additions to an allowance for bad debts. Insurance companies are permitted a deduction on bad debts only on a specific charge-off basis.

   2. Charitable contributions are limited to of 10 percent of the LICTI before a deduction of such contributions, or of loss carrybacks, dividends to policyholders, dividend received deduction, and the small life insurance company deduction, and all other allowable deductions.

   3. In addition, a loss from a noninsurance business is limited by the Code to the lesser of 35 percent of the life insurance taxable income or 35 percent of the nonlife loss.

Adjustments Unique to Life Insurance Companies

13.10 *Deferred Contract Acquisition Costs.* In 1990, ~~in an effort to increase the tax burden on the life insurance industry,~~ Congress enacted a tax law change requiring life insurance companies to capitalize contract acquisition costs. Due to the complexity of determining contract acquisition costs and the amortization methods, the tax law requires the use of a proxy method. Under this approach, the "deemed contract acquisition cost" is determined by multiplying the net premiums on *specified insurance*

13.9b

b. *Deduction for increase in tax basis benefit reserves*. If the tax basis benefit reserves at the end of the year are larger than the tax basis benefit reserves at the beginning of the year, the increase is included as a deduction for increase in the ~~statutory~~ basis benefit reserves. If the ~~statutory~~ basis benefit reserves at the
tax beginning of the year are larger than the ~~statutory~~ basis benefit reserves at the end tax
of the year, the excess is included in income as a decrease in the ~~statutory~~ basis benefit reserves. The following items are included in computing the change in a life insurance company's tax basis benefit reserves: (1) life insurance tax basis reserves; (2) unearned premiums and unpaid losses; (3) the discounted amounts necessary to satisfy obligations under insurance or annuity contracts not involving life, health, or accident contingencies; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts; (5) premiums received in advance and liabilities for premium deposit funds; (6) reasonable special contingency liabilities under contracts of group term life insurance or group accident and health insurance that are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.

13.9b.1

1. *Computing tax basis reserves for life insurance benefits*. Tax basis reserves for life insurance benefits are determined under special provisions of the tax law, which specify the calculation method, interest rate, and morbidity and mortality tables to be used. Generally, life insurance contracts should be valued by the statutory commissioners' reserve valuation method (CRVM), and annuity contracts should be valued by the statutory commissioners' annuity reserve valuation method (CARVM). Both methods are prescribed by the NAIC. A two-year full preliminary term method is used for noncancellable accident and health insurance statutory reserves. Beginning in 1988, the interest rate used should be the greater of the *applicable federal interest rate* as prescribed by the IRS or the *prevailing state assumed interest rate*, which is the highest interest rate for statutory reserves permitted by at least twenty-six states. The Code also provides that the *prevailing commissioners' standard tables for mortality and morbidity*, which is the table permitted by at least twenty-six states, should be used in calculating tax basis statutory reserves for life insurance benefits. The tax basis ~~statutory~~ reserves for life insurance benefits are the greater of the reserves computed as described above or the net surrender value. However, the tax basis ~~statutory~~ reserve for life insurance benefits may not exceed the statutory reserve amounts. This calculation shall be done on a contract-by-contract basis.

2. *Tax adjustments for nonlife statutory reserves*. Cancelable and nonrenewable accident and health insurance contracts are subject to the statutory unearned premium reserve reduction and the unpaid loss discounting tax rules related to property and casualty insurance companies. For taxable years after 1990, the statutory unearned premium reserve of such contracts must be reduced by 20 percent.

c. *Proration of tax exempt interest and dividends received deduction*. Normally, tax exempt interest and dividends are excluded or partially excluded from taxable *contracts* by a fixed capitalization rate. Specified insurance contracts are defined in the tax Code as any life insurance, annuity, or noncancellable or guaranteed renewable accident and health insurance contract (or any combination thereof). The capitalized amounts generally will be amortized over 120 months on a straight-line basis. Certain small life companies may qualify to accelerate to a sixty-month amortization period.

13.11 In applying the proxy method, the following percentages of net premiums of the specified insurance contracts, written directly or through reinsurance, are capitalized:

Types of Contracts (a)	
Annuities	1.75%
Group life	2.05%
Other life (including noncancellable or guaranteed renewable accident and health)	7.70%

(a) Premiums for qualified pension plans are not subject to the DAC tax.

The capitalized amount is limited to the company's total *general deduction* for that year. General deductions includes the deductions allowed as general trade or business deductions, interest and taxes, depreciation, and so on. It does not include death benefits paid, policyholder dividends, the dividend received deduction, and the operations loss deduction.

13.12 *Operations Loss Deduction (OLD)*. Whereas nonlife insurance companies may generate net operating losses (NOLs), a life insurance company with a net taxable loss will generate an OLD. OLDs are generally subject to a three-year carryback and a fifteen-year carryforward limitation, except for those companies that qualify as new life insurance companies, which are permitted an additional three years.

13.13 *Small Life Insurance Company Deduction*. A small life insurance company deduction is allowed to life insurance companies with gross assets of less than $500 million determined at year end on a controlled group basis. The deduction is equal to 60 percent of the first $3 million of tentative LICTI. The deduction is phased out at the rate of 15 percent of the amount in excess of $3 million and is completely phased out when tentative LICTI equals $15 million.

13.14 *Differential Earnings Amount for Mutual Life Insurance Companies*. The equity interest of a stock life insurance company is held by the stockholders. By contrast, the equity interest of a mutual insurance company is held by its contractholders. A perceived inequity was identified since the return on investment to stock life companies (that is, stock dividends) is not deductible to the company, yet the return on equity to mutual company "equity owners" is deductible as a contractholder dividend.

13.15 In recognition of the presumption that part of contractholder dividends paid by mutual companies could be construed as distributions of the companies' earnings to the contractholders as owners, a mechanism was introduced into the law attempting to equalize the taxation of mutual life insurance companies and stock life insurance companies.

13.16 The mechanism chosen to apply this theoretical approach of identifying ownership distributions by a mutual company is called the *differential earnings amount* (DEA). The DEA is computed by multiplying the company's average equity base for the taxable year by the *differential earnings rate* (DER). The DER is computed by the IRS based on earnings reported by all mutual life insurance companies and the fifty largest stock life insurance companies. The DEA reduces otherwise deductible policyholder dividends since it approximates the earnings distributed by the mutual insurance company. The excess of the DEA over policyholder dividends for the taxable year should reduce the ending statutory reserves of the mutual insurance company.

13.17 The DER computed by the IRS is generally not available prior to the completion of the audited financial statements. However, various industry groups may provide estimates of the current year DER. The IRS has indicated that the DER cannot be negative.

13.18 *Phase III Income*. Under pre-1984 law, a portion of stock life insurance company taxable income was tax deferred indefinitely, and accumulated in a tax memorandum account referred to as *policyholders' surplus account* or *phase III income*. As a result of the 1984 changes, stock life insurance companies no longer defer taxation of any portion of their taxable income; however, the previously deferred pre-1984 income remains tax deferred to the extent that (a) the life insurance company does not distribute such income to its shareholders, (b) the company retains its status as a life insurance company, and (c) the company maintains minimum levels of tax basis reserves or premiums.

Reductions in the policyholders' surplus accounts (phase III income) are included in taxable income in the year in which such a reduction occurs. Phase III income cannot be offset by net operating losses.

13.19 *Dividends-Received Deduction*. As with nonlife insurance companies, life insurance companies are generally entitled to a dividends-received deduction; ~~however, special rules apply to life insurance companies.~~ This deduction is determined in part on the life insurance company's ownership of the dividend paying company.

Computation of Federal Income Tax Liability

13.20 The computation of federal income taxes is generally the same as in other industries. The Internal Revenue Code provides two systems of income taxation for all taxpayers including life insurance companies, the regular tax (taxable income is determined as described above and the tax is determined by applying the regular income tax rates to such taxable income) and the alternative minimum tax (AMT). An entity's federal income tax liability is the greater of regular income tax or the alternative minimum tax.

?

13.21 The AMT is a tax system that parallels the regular income tax system. It is intended to tax those entities with little current taxable income but significant financial reporting earnings. For the purpose of calculating the AMT, taxable income is adjusted by certain amounts as specified by the Code to arrive at alternative minimum taxable income (AMTI). The alternative minimum tax is generally 20 percent of the AMTI. The AMT is the excess of AMTI over the regular tax liability.

13.22 *Tax Payments*. As is the case with other business entities, a life insurance company must make estimated tax payments on April 15, June 15, September 15, and December 15. A life insurance entity that does not base its estimated tax payments on 100 percent

13.31

b. Advance Premiums and Premium Deposit Funds	and reported as liabilities on balance sheet.	income.
c. Experience Rated Refunds	Often netted against premium and annuity considerations.	Deductible as policyholder dividends.
Investment Income • Interest Income —Tax Exempt Interest Income —Proration	• Included in gain from operations income. • N/A	• Policyholder's share included in LICTI via decrease of ending tax basis reserves. ? • Increases the percentage of tax exempt interest income and dividends received which are subject to tax.
—Market Premium and Discount on Bond Obligations	Amortized and accrued currently.	• Option available not to accrue market discount currently. • Unaccrued market discount realized upon disposition may be ordinary income for certain obligations.
—Original Issue Discount	Same as Market Premium above.	Must accrue original issue discount currently.
• Dividend Income	Included in gain from operations	Generally included in taxable income, except some amounts may be reclassified as return of capital or capital gain depending on the paying entity's circumstances.
• Rental Income	Included in operations income. May include an amount for occupying company owned real estate (imputed rent).	Imputed rent is eliminated.
• Royalty Income	Included in operations income.	Various adjustments may be required depending on the nature of the activity that generates the income.
	Included in operations	

- Due and unpaid accident and health premiums (more than one modal premium past due for individual contracts, or ninety days past due for group contracts)
- Cash advances to officers and employees
- Accrued income on investments in default
- Excess of amounts loaned over stipulated percentages of related collateral
- Prepaid and deferred expenses
- Goodwill and similar intangible assets
- In a few states, amounts recoverable from unauthorized reinsurers, unless covered by amounts due to such reinsurers (in other states, a separate liability is required to be established for such amounts)
- Excess of book value over admitted asset value of securities and other investments (see chapter 11 for further discussion)

14.4 SAP specifically designates certain assets as nonadmitted, while state laws may designate additional assets as nonadmitted. Most of the preceding nonadmitted assets are self-explanatory. In general, receivables (other than those due from contractholders) should be classified as nonadmitted assets unless they are collateralized. Life insurance entities maintaining accounts for furniture and other equipment and charging operations with depreciation are generally required to treat undepreciated balances as nonadmitted assets; however, some states permit furniture and equipment to be treated as admitted assets in amounts up to stipulated percentages of the aggregate of all other assets. Unauthorized investments and investments in excess of amounts authorized by statute are nonadmitted (see chapter 11 for discussion). In many states, insurance entities are not permitted to own their own stock, and loans collateralized by such stock are also classified as nonadmitted assets.

14.5 Changes in nonadmitted assets between valuation dates are charged or credited directly to surplus, except for the change in nonadmitted investment income due or accrued, which is included as part of investment income.

14.6 Under GAAP, the concept of nonadmitted assets does not exist. These assets should be included in the balance sheet, where appropriate. Any receivables must be subject to the usual review as to collectibility, and appropriate valuation reserves should be established by a charge to income. Any amounts capitalized and amortized or depreciated should be reviewed for appropriate calculations and recoverability where applicable.

OTHER LIABILITIES (including benefit obligations)

14.7 Other liabilities generally consist of accrued expenses, taxes, licenses, and fees (see chapter 10 for a discussion). Additional other liabilities unique to life insurance entities may include—

- Amounts withheld or retained by the life insurance entity as an agent or trustee, 14.7 such as payroll withholdings and amounts held in escrow for payment of taxes and insurance under mortgage loans.

- Amounts held for agents, which generally represent credit balances in agents' accounts.
- Remittances and items not allocated, which represent cash clearing accounts and other suspense accounts (see chapter 7, paragraph 37, for a discussion of suspense accounts).
- Liabilities for employee benefits not provided in other accounts, such as a liability for accrued or unused vacations, nonqualified pension plans, and postemployment benefits. Delete
- Commissions to agents due or accrued, including levelized commission agreements.
- Reinsurance in unauthorized entities (see chapter 12 for a discussion).
- Liabilities for amounts held under uninsured accident and health plans (referred to as *administrative services only*). Liabilities relating to one plan may not be offset by assets relating to a different plan.

SURPLUS NOTES

14.8 Practice Bulletin 15, *Accounting by the Issuer of Surplus Notes,* provides GAAP guidance on accounting for surplus notes. Surplus notes[1] are financial instruments issued by insurance enterprises that are includable in surplus for statutory accounting purposes as prescribed or permitted by state laws and regulations.

14.9 The following are some general characteristics of surplus notes:

- Approval of the issuance by the domiciliary state insurance commissioner (commissioner)
- Stated maturity date in most but not all cases
- Scheduled interest payments
- Approval of the payment of principal and interest by the commissioner
- Nonvoting
- Subordinate to all claims except those of shareholders for stock companies policyholder liabilities are settled)
- No or limited acceleration rights other than for rehabilitation, liquidation, or reorganization of the insurer by a governmental agency
- Proceeds from issuance in the form of cash, cash equivalent, or some other asset with a readily determinable fair value satisfactory to the commissioner

14.10 Mutual insurance enterprises are owned by their policyholders and cannot raise

Appendix C — Life Insurance Entity Specific Disclosures

previous next

LIFE INSURANCE ENTITY SPECIFIC DISCLOSURES

The disclosures in this appendix are life insurance specific disclosures. General disclosure requirements are not included in this appendix.

GAAP DISCLOSURES IN FINANCIAL STATEMENTS

Investments

1. Carrying amounts of investment securities on deposit with regulatory authorities should be disclosed.

2. The disclosure requirements of FASB Statement No. 115 require that for securities classified as available-for-sale, and separately for securities classified as held to maturity, entities disclose the aggregate fair value, gross unrealized holding gains, gross unrealized holding losses, and amortized cost basis by major security type as of each date for which statement of financial position is presented. The following major security types should be included in this disclosure, though additional types also may be included as appropriate:

   a. Equity securities
   b. Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies
   c. Debt securities issued by states of the United States and political subdivisions of the states
   d. Debt securities issued by foreign governments
   e. Corporate debt securities
   f. Mortgage-backed securities
   g. Other debt securities

3. Adjustments to deferred acquisition costs and other assets and liabilities as a result of including unrealized gains or losses as part of shareholders' equity should be disclosed.

Financial Instruments

4. The disclosure requirements of FASB Statement No. 105 and 107 as amended by FASB Statement No. 119 should be considered. Superceded by FAS 133

5. According to FASB Statement No. 119, entities should disclose financial instruments with off-balance sheet risk, financial instruments with concentrations

c. Whether the insurance entity considers anticipated investment income in determining if a premium deficiency relating to short-duration contracts exists

10. SOP 94-5 states that for each period in which an income statement is presented the following should be disclosed:

a. The balance in the liability for unpaid claims and claim adjustment expenses at the beginning and end of the period presented, with, if net balances are presented, separate disclosure of the related amount of reinsurance recoverable

b. Incurred claims and claim adjustment expenses with separate disclosure of the provision of insured events of the current period and for increases or decreases in the provision for insured events of prior periods

c. Payments of claims and claim adjustment expenses with separate disclosure of payments of claims and claim adjustment expenses attributable to insured events of the current period and to insured events of the prior period

11. SOP 95-4 also requires entities to disclose the reasons for the change in the provision for incurred claims and claim adjustment expenses attributable to insured events of prior periods and whether additional premiums or return premiums have been accrued as a result of the prior-period effects.

12. EITF 93-5 states that, if liabilities are discounted, insurance entities should disclose the undiscounted amounts of the liability and any related recovery, and the discount rate used.

Delete

This guidance for Insurance Companies was nullified by SOP 96-1, Paragraph 101.

Liabilities for Future Policy Benefits

13. According to FASB Statement No. 60, requires insurance entities to disclose the methods and assumptions used in estimating the liability for future policy benefits and encourages disclosure of the average rate of assumed investment yields in effect for the current year.

Income Taxes

14. Insurance entities must disclose the portions of retained earnings in excess of statutory unassigned surplus upon which no income tax provisions have been made and the reasons therefore.

Stockholder's Equity

15. According to FASB Statement No. 60, insurance entities should disclose the following in their financial statements the following information relating to stockholders' equity, statutory capital and surplus, and the effects of statutory accounting practices on the entity's ability to pay dividends to stockholders:

a. The amount of statutory capital and surplus

b. The amount of statutory capital and surplus necessary to satisfy regulatory

(13)

December 20, 1998

California Society
Certified Public Accountants

Ms. Elaine M. Lehnert
Technical Manager, Accounting Standards
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

RE: File 3162.LG: Proposed Audit and Accounting Guide for *Life and Health Insurance Entities* (to supersede the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*)

Dear Ms. Lehnert:

The Accounting Principles and Auditing Standards (AP&AS) Committee of the California Society of CPAs have discussed the proposed exposure draft for the Audit and Accounting Guide *Life and Health Insurance Entities* and would like to comment on it.

The AP&AS Committee is the state society's senior technical committee. The committee is composed of 52 members, of whom 8 percent are from national CPA firms, 63 percent are from local or regional firms, 19 percent are sole practitioners in public practice, 6 percent are in industry and 4 percent are in academia.

The AP&AS Committee supports issuance of the proposed Audit Guide but suggests consideration be given to increasing the auditors awareness of the need to audit asset transfers made to service providers in connection with ongoing claims.

It has come to the attention of our committee that insurance companies may advance funds to a service provider for the purpose of the provider paying for or providing future services. Unfortunately, these service providers may use these advanced funds to pay for prior obligations and therefore be unable to provide the intended future services to the insured.

The practice of insurance companies transferring funds to service providers for future obligations of the insured are addressed to some extent in paragraph 4.7 in the exposure draft. However, the committee feels that further clarification of this risk is needed and would be beneficial.

We, on the AP&AS Committee, appreciate the opportunity to respond and would be pleased to discuss our comments further.

Very truly yours,

A Mintzer

Andy Mintzer, Chair
Accounting Principles and Auditing Standards Committee

AM/JJH:sm

c: James R. Kurtz, Executive Director
Diana Sanderson, President

275 Shoreline Drive
Redwood City, CA
94065-1407

(650) 802-2486
www.calcpa.org

File 3162.LG

PRICEWATERHOUSECOOPERS

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PricewaterhouseCoopers LLP
101 Hudson Street
Jersey City NJ 07302
Telephone (201) 521 3000
Facsimile (201) 521 3333

April 1, 1999

Ms. Elaine M. Lehnert
Technical Manager, Accounting Standards
File 3162.LG
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Proposed Audit and Accounting Guide, *Life and Health Insurance Entities*

Dear Ms. Lehnert:

PricewaterhouseCoopers LLP appreciates the opportunity to review and comment on the American Institute of Certified Public Accountants' Exposure Draft of the proposed Audit and Accounting Guide, *Life and Health Insurance Entities* (the Guide). Overall, we support the final issuance of the Guide. This update is long overdue and should be issued as expeditiously as possible. We apologize for the delay in providing our input and respectfully submit the following comments for your consideration.

Preface

P-7 Now that the National Association of Insurance Commissioners (NAIC) plenary has adopted "Codification," this paragraph should be modified to reflect the current status of the project. We suggest that wording similar to the proposed change to paragraph two of Statement of Position (SOP) 94-1, *Inquiries of State Insurance Regulators* to be considered.

Chapter 1

1.59 The Guide should discuss the fact that there are other insurance related assessments. Also, it should be noted that some states allow premium tax-offsets for guaranty-fund assessments.

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1.7 We believe the guide should include discussion regarding the mutual holding company structure. At a minimum reference should be made to the ongoing Insurance Companies Committee (ICC) project related to mutual holding companies and demutualization.

Chapter 2

2.39 This paragraph discusses variable annuities as having benefit payments whose value may fluctuate over the payment period. Note that some are variable during the accumulation phase and offer only a fixed payment during the annuity phase. Additionally, the recent explosion of equity-indexed annuity products should merit some discussion (i.e. description of common products and that they have traits of both fixed and variable annuities). Consideration should also be given to mentioning the current ICC project related to non-traditional long-term products.

Chapter 3

3.12 Insert "and other third-party vendors" after NAIC.

3.22 Last paragraph, delete "Because … by FASB No. 60," and start sentence "The scope …" FASB No. 60 definition includes life claims.

Table 3.1 Consider discussing NAIC Securities Valuation Office categories (i.e. category 1.6). They are used in this table, but not defined elsewhere.

Table 3.1 "Unrealized Gains ("losses") - GAAP ⇒ Caption should read: Recorded in net income or other comprehensive income, as appropriate (except for held-to-maturity).

Table 3.1 Should there be a caption for purchase business combinations or derivatives?

Chapter 4

General Include bullets for adequacy of systems, sophistication of management, and litigation.

Chapter 5

5.43 In Situation 1, the example may need clarification as to who would be providing the NAIC's Statutory Reserve Certification and the auditors responsibility re: independence for insurance companies registered with the SEC (i.e., SEC Practice Sections 1000.35).

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Chapter 6

6.7-6.9 Considerations should be given to discussing tests of controls for the inforce file. Auditors may assess control risk at something other than maximum. Therefore a general discussion of control procedures would be helpful here or in Chapter 5.

Chapter 7

7.8 Life insurance entities generally record premiums as revenue when received or due? (Also in 7.8a)

7.8c Deferred Premium: Consider the following definition instead:

Deferred premiums result from the combination of mean reserves and the assumption of a premium annual payment mode. The assumption of annual payment of premiums may not agree with actual facts. Premiums may be due more frequently than annually (modal Premiums). In this situation the company's policy reserves usually overstate its true liabilities. More premiums are assumed to have been received than are due. The method used to correct this overstatement of liabilities is to increase assets by the amount of premiums needed to justify the assumption: the "deferred" net premiums which represent the modal premiums which are due after the valuation date and prior to the next policy anniversary.

The change in the deferred gross premium asset is included in premium income to arrive at the accrued basis. The excess of the gross deferred premium over the net deferred premium ("loading") is deducted as an expense.

7.13 Second sentence: In defining net premium, replace "all contract benefits and maintenance...." with "all contract benefits and expenses." This definition is straight from FAS 60. As written the Guide may not intend the same meaning, but it is using the same terminology that is used when considering premium deficiencies. Premium deficiency consideration can include interest assumptions which is not part of net premium.

7.20 Third sentence: Is this sentence repetitive with the fifth and sixth sentences?

Chapter 8

8.1 This paragraph discusses the need for a liability because of the certainty of death and the possibility of cash accumulation benefits. Under term contracts death may not be certain and there is no cash accumulation (i.e. 10-year term or guaranteed renewable term).

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8.7 All states have adopted the Model Standards Valuation Law rather than most. The Guide is correct in stating that variations exist by state.

8.36 Last sentence: Edit as follows " . . gross premium are significantly ~~more favorable~~ *different* than the corresponding assumptions permitted in determining statutory reserves [*or gross premiums are significantly impacted by outside market factors*]."

8.60-8.77 Consideration should be given to adding a discussion about unpaid claims for short duration like contracts (e.g. term insurance) and expanding the discussion of health insurance (e.g. medical coverage as opposed to disability).

8.71 Consider this edit to the second sentence "during which the contract is *generally* a FAS 97 contract (*in practice, most contracts do not have significant mortality/morbidity risk),* and …"

8.72 This paragraph implies that all annuities in payout phase have mortality risk. This ignores period-certain contracts. Accounting for these contracts should be discussed.

8.105 Define new money rates.

Chapter 9

General Given the increased amounts of fraud in accident and health and disability claims, it may merit a discussion of the requirements by many states to have a formal fraud detection and monitoring program.

Chapter 10

General Nowhere in the audit guide is there a discussion on "present value of future profits" (i.e. PVFP) for life insurance entities. Given the current trend in consolidations, this can be a very material number. We would expect that there would be discussion of this topic in either Chapter 10 or Chapter 14 Other Assets. Discussion should include EITF 92-9, *Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company.*

10.19 The phrase "do not require a reserve to be provided" is confusing (i.e. most don't consider DAC to be a reserve). Consider instead "are not required to be capitalized".

10.12,10.21 10.34,10.58 and 10.68 Where the term "gross profits" is used, the following should be added "(or gross margins for SOP 95-1 contracts)"

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10.25 Expand the discussion of excess amortization and estimates in gross profits to include a note that a common reason for changes in the estimate of gross profits relates to realized gains and losses from investment securities. Given the declining interest rate environment, many securities sold have realized gains ergo excess amortization. Also, include a reference to the discussion of shadow DAC in Chapter 11.

10.31 Last sentence states that "Following the change, the new basis of amortization should be consistently applied in future periods." We suggest that guidance be expanded to clarify that we would still apply the SOP 95-1 and FAS 97 "retrospective cumulative catch-up" approach, under which the new basis would be applied beginning from inception and the resultant cumulative difference recorded in the current year.

10.38-10.48 This section discusses (1) recoverability testing "in year of issue" and states that recoverability tests are defined as profitability tests of a group of contracts issued in a given year, and that such test is only performed in the year of issue and (2) loss recognition/premium deficiency tests of all years -- as two separate and distinct calculations. Although this is done in practice, there is no explicit requirement for year of issue recoverability test in FAS 60, and thus authoritative GAAP reference for this guidance should be referenced and how it integrates with the premium deficiency test specified in FAS 60 par. 32 which, requires grouping contracts based on company's method of acquiring, servicing and measuring profitability.

10.46 While this paragraph is a reprint of FAS 60 par. 36, you may want to note that in practice Companies first reduce the DAC balance to zero, and then increase the benefit reserve if necessary. Similar to guidance in 10.40.

10.43 Should include description of how premium deficiency is calculated for short duration contracts (i.e. explain guidance in FAS 60, par. 33-34.).

10.44 Sentence that "For these contracts, it is anticipated that the original assumptions will continue to be used during the period ..." is not applicable to FAS 97.

10.51-10.52 Guidance on internal replacements implies there is free choice on other than FAS 97 replacements to either consider the replacement as continuation of the old contract or initiation of a new one. Shouldn't guidance instead emphasize that it is dependent on facts and circumstances (and perhaps reference EITF 96-19, *Debtor's Accounting for a Modification or Exchange of Debt Instruments* on debt modifications as analogy)? Also, paragraph describes the disclosure of a change in accounting principle in the entity's reports to shareholders/contractholders. The Guide should be discussing disclosures in financial statements, not reports to

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shareholders.

Chapter 11

General	Mention that securities transactions should be recorded on trade date (and that many insurance companies use settlement date). Also, mention existence of FAS 115 Implementation Guide?
11.3	Mention derivatives?
11.7	There are now two model investment laws, one is defined standards and the other is defined limits. Neither is an accreditation standard, and **per the NAIC's summary, no state has adopted the defined limits version**. The defined standards versions was just approved as final at the December meeting, so it is doubtful any state has adopted it either.
11.10 c.	"...deferred income taxes, amounts attributable to policyholders, and DAC (...) as a separate component of ~~stockholders' equity~~ *other comprehensive income ...*"
11.13	Consider adding that in practice this topic is referred to as "Shadow DAC".
11.18-11.24	No SAP accounting guidance is provided.
11.22	Appears a word is missing at the end of the first sentence; should it be security?
11.23	Second sentence is out of place, as it is referring to "substantially the same" criteria for sales accounted for as borrowings, while first sentence is discussing repurchase agreements treated as sales. Similar to par. 11.20 for securities lending, should indicate that many repurchase agreements will result in financing treatment.
11.34	Update for FAS 133.
11.47,11.48 11.51	Should be updated to reflect "other comprehensive income" treatment of unrealized gains and losses.
11.73	For assets held for investment, say recorded at cost less accumulated depreciation, and note FAS 121 impairment rules (i.e. direct writedown, establishing new cost basis and recorded as realized loss).
11.72,11.73	Discussion of real estate acquired in settlement of debt should be expanded.

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Chapter 12

12.13 Consider mentioning "funds withheld" as another type of agreement.

12.14 Expand discussion of experience-rated contracts.

12.25 Reference should be made to SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk* (SOP 98-7).

12.27 Last sentence says assumption reinsurance transactions may result in immediate gain/loss recognition. Revise to say generally, and then indicate instances, if any, when it wouldn't. Also should include guidance that even when executed through assumption reinsurance, there may be a period during conversion to assumption (i.e., period when contractholder acceptance is still outstanding) when reinsurance accounting would still apply.

12.28 Second and third sentences both describe accounting for prepaid insurance premiums. Suggest that the following words be deleted from the second sentence: ~~, and should report any prepaid reinsurance premiums~~. This is consistent with paragraph 14 of FAS 113.

12.29 Reinsurance receivables ~~and prepaid reinsurance premiums~~ should be recognized in a manner consistent with the related liabilities. (FAS 113, par. 20)

12.31 Last sentence "Prospective reinsurance agreements are the most common for short duration contracts in the life insurance industry." What does this mean? Should we say instead that in practice they are more common than retroactive short duration contracts?

12.36 Need expanded guidance on par. 26 of FAS 113. Also, What is meaning of first bullet, last sentence and second bullet last sentence?

12.37 Update footnote 1 for final issuance of SOP 98-7.

Chapter 13

General Mention retaliatory taxes?

13.12 Insert at the end of the paragraph the following text:

The Taxpayer Relief Act of 1997 (h2014), modified the Net Operating Loss (NOL) carryback and carryforward rules under Internal Revenue Code § 172 from a three-year carryback and a fifteen-year carryforward to a two-year carryback and a 20-year carryforward. While there was no change to the OLD rules under IRC § 810, companies should be mindful of the NOL change and watch for a potential technical correction to bring the OLD rules in line with the NOL rules.

13.17 Insert at the end of the paragraph: "This has been consistently sustained by the courts."

13.29 Do you want to discuss impact of Codification?

Chapter 14

14.8 Need discussion of capital notes in the surplus notes section.

14.20 "Assets of the separate account are generally reported at fair value." Add discussion of book value separate accounts. Also, mention existence of separate account asset diversification requirements (tax implications).

14.25 Reference guidance in chapter 10 for DAC amortization method (i.e. FAS 97 or FAS 91) and delete third sentence of paragraph.

14.26 Expand to acknowledge existence of products with some guarantees, and non-traditional products such as equity-indexed annuities and MVA's. Expand to include GAAP classification and valuation of "seed money".

14.27 Expand to discuss sponsor company financial statement reporting requirements, including special rule for mutual life companies.

14.30.1 Expand to discuss filing requirements for variable life insurance products (e.g. S-6), as only variable annuities are currently mentioned. Also expand to discuss products which are effectively general account products for which the insurance entity is the registrant and Form S-1 or other 1933 registration is required.

14.34.1 First sentence say "*some of* which are unique." Also, as further examples, add bullets change in accounting methods/policies and error correction.

Chapter 15

15.7-15.10 This is taken from SAS 58, as revised by SAS 79. An example would be useful because we believe FAS 5 requires management to evaluate the uncertainty and form a conclusion. We think instances would be rare in which there was insufficient evidential matter, otherwise we think we would have to conclude that management did not follow FAS 5. We're afraid too many auditors will view this

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as an easy out, rather than forcing management's hand. At any rate, an example might cure the problem.

15.19 Should discuss disclaimer for going concern mentioned in 15.17.

15.31 Should note that in instances where GAAP differences are known, they are to be quantified in notes to financial statements, not just narratively described (This is described in limited fashion in par. 15.29 and should be expanded to provide alternative disclosure suggestions.).

We appreciate the opportunity to express our views. If you have any questions regarding our comments, please contact James F. Harrington at (201) 521-3519 or Jim Pearson at (203) 316-5763.

Very truly yours,

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP